Best Practices

Considerations in Applying Multilevel Discounts to Tiered Entities

Weston C. Kirk

Multilevel valuation discounts applied to multitiered entity ownership interests are often subject to dispute. Complex ownership interests considered as part of a gift, estate, or generation-skipping tax valuation may involve multitiered ownership interests. Therefore, the valuation of these tiered ownership interests may incorporate multilevel valuation discounts for (1) lack of control, (2) lack of marketability, (3) lack of voting rights, and/or (4) other valuation adjustments (e.g., market absorption). The valuation of multitiered interests should take into consideration many factors, including, but not limited to, (1) prior court decisions involving the transfer of multitiered ownership interests, (2) the standard of value and the purpose of the analysis, (3) the level of value of the ownership interest being valued at each tier, (4) the risks associated with the assets held by the tiered entity, (5) the risks associated with the contractual restrictions of tiered ownership interests, (6) the avoidance of double discounting, and (7) the overall reasonableness of the discounts applied to reach the value conclusion of the subject interest. These considerations should be made during the valuation analysis to develop reasonable support for the valuation conclusion and, thus, the value at which the subject interest may be exchanged.

Introduction

Multilevel valuation discounts are often appropriate in the valuation of complex, multitiered business interests for various tax-related transfer purposes.

A tiered business entity is defined as a company that owns an interest in another company. That is, there exists an upper tier entity that owns an interest in a lower tier entity.

The reasonableness, support, and application of multilevel discounts (i.e., discounts at the upper tier and lower tier) are often disputed by the Internal Revenue Service (the "Service").

Many considerations should be applied during the valuation analysis. Such considerations should be supported by the analyst in the written report and the supporting exhibits. The following discussion sets forth the considerations in applying multilevel discounts to tiered entities.

Multitiered Entity Valuation Considerations

A multitiered entity structure involves multiple tiers of investment interests as independent legal entities or defined subordinate investment assets, such as an investment portfolio. The upper tier may be a holding company of underlying lower tiered entities or the upper tier may be an operating entity with multiple assets with one or more of those assets being investments/ownership in another entity.

Lower tier entities may be a mix of (1) controlling or noncontrolling ownership interests, (2) marketable or nonmarketable ownership interests, (3) voting or nonvoting ownership interests, or (4) operating or nonoperating business/asset interests. The tiered entities may be interrelated to the other tiers or independent of the other tiers.

The various structures in which multitiered entities can be constructed or inadvertently established

are numerous. Some multitiered structures may have four or more tiered levels. These unique ownership structures can make the valuation of multitiered entities a complex task.

The following sections outline some of the common considerations in the valuation of multitiered entities, including the following:

1. Prior court cases involving the transfer of multitiered ownership interests
2. The standard of value and the purpose of the analysis
3. The ownership interest level of value at each tier
4. The risks associated with the assets of the tiered entity
5. The risks associated with contractual restrictions of tiered ownership interests
6. The avoidance of double discounting
7. The overall reasonableness of the discounts applied to reach the value of the subject interest

This list does not contemplate all considerations that should be applied in the valuation of such unique ownership interests. The analyst's experience, due diligence, and forethought are needed to value any complex ownership interest.

Prior Court Case Considerations

The U.S. Tax Court, as well as other federal courts, has opined on the appropriateness of tiered valuation discounts. The *Astleford*,[1] *Dean*,[2] *Gallun*,[3] *Gow*,[4] *Hjersted*,[5] *Kosman*,[6] *Piper*,[7] and *Whittemore*[8] court cases each allowed some magnitude of tiered discounts; *Martin*[9] largely disallowed multilevel discounts; and *Janda*,[10] *O'Connell*,[11] and *Ringgold*[12] disallowed multilevel valuation discounts for various unique reasons.

In a majority of these cases (9 out of 12), the Service's analyst/engineer applied some level of tiered valuation discounts in his or her analysis.

An in-depth review of these court cases (excluding *Ringgold*) is presented in "Multitiered Discounts for Tiered Entities—Insights from Historical Case Law"[13] by James Rabe. The Ringgold case is discussed in more detail in the Autumn 2010 edition of *Insights*.[14]

Although the Service generally challenges the application of tiered valuation discounts especially (1) as they relate to valuations of entities of significant size from a dollar perspective and (2) where the implied combined discounts are material to the subject interest's undiscounted value, the courts have supported multilevel discounts in tiered entities. In fact, in a majority of the aforementioned cases, the courts allowed multilevel discounts.

The inferences made from these prior court cases are as follows:

- *Astleford*, *Martin*, and *O'Connell* concluded that an important factor to consider when applying discounts at the upper tier is the composition of the assets in that upper tier entity.
- *Astleford* concluded that multilevel valuation discounts for tiered entities are appropriate when the lower tier interest constitutes a relatively small percentage of the upper tier entity's assets.
- *Martin* and *O'Connell* concluded that multitiered valuation discounts are largely inappropriate when the lower tier interest constitutes a significant portion of the upper tier entity's assets.
- Although *Martin* largely disallowed multilevel valuation discounts by stating that the taxpayer's expert's "second stage 50-percent discounts were mostly duplicative of the 50-percent discounts applied at the level of the underlying corporations," the Tax Court did accept both a combined discount for lack of control and lack of marketability of 70 percent at the lower tier and a 5 percent discount at the upper tier.
- In *O'Connell* the lower tier was discounted by 30 percent for lack of marketability; whereas, the upper tier was not discounted as it represented a controlling 95 percent interest.
- *Dean* and *Gallun*, concluded that (1) lower tier investment portfolios may be discounted based on blockage (i.e., illiquidity in the market place) and other control factors and (2) the upper tier entity may be discounted to value the subject interest accordingly.
- *Gow* concluded that relatively significant discounts should apply at the lower tier and upper tier entity due to the control and marketability risks applicable to the respective noncontrolling ownership interests at the lower tier and at the upper tier. *Gow* involved a lower tier entity operating as a joint venture real estate time share that was under development.
- *Hjersted*, after appeal to the Kansas Supreme Court, concluded that as long as the transfers were made based on normal estate planning objectives, and not solely to disinherit the wife, multilevel discounts

would be appropriate and not precluded as the earlier courts had found. The court allowed discounts for (1) the lower tier, which held all of the outstanding stock of a chemical manufacturing company and (2) the upper tier, which held a 96 percent limited partnership interest.

- *Kosman* concluded that (1) discounts for lack of control and lack of marketability were applicable at the lower tier (minority ownership in two privately held bank stocks) and (2) discounts for lack of control, marketability, and voting rights (exclusively for the subject nonvoting interest) were applicable at the upper tier (a voting and nonvoting minority interest in the holding company of the lower tier investment).
- *Piper* concluded modest multilevel discounts to noncontrolling interests in two entities, each of which held nonregistered shares in a publicly traded manufacturer of light aircraft, real estate, and cash. *Piper* is a noteworthy case because in considering the appropriate discounts, the Tax Court rejected testimony regarding discounts based simply on the average discount from the selected studies, such as the restricted stock studies, and favored testimony regarding discounts based on (1) the underlying data in the studies and guideline securities and (2) a comparison of the characteristics of the subject company to the studies and guideline securities.
- *Whittemore* concluded significant multilevel discounts (11.8 percent for blockage at the lower tier [a noncontrolling interest in an over-the-counter publicly traded company] and 66.1 percent for lack of control and marketability at the upper tier [a holding company]) that were further supported by the Services' multilevel discount approach.
- *Janda* concluded that although no valuation discount was applicable to the lower tiered ownership interest that represented 94.6 percent ownership interest in a closely held bank (a position held by both the Service's expert and the taxpayer's expert), a combined 40 percent discount (for lack of control and lack of marketability) was applied at the upper tier (a noncontrolling interest in a holding company).
- *Ringgold* concluded that multilevel discounts were not appropriate in the valuation analysis as the lower tier (a noncontrolling interest in a wireless telecommunications services company) was subsequently sold to BellSouth 6 months after the valuation date, and such information was pertinent in determining the value of the lower tier even though the transaction closed subsequent to the valuation date. It is probable that the court decided the noncontrolling interest was acquired at a noncontrolling (i.e., discounted) value which would mitigate the need to further discount the lower tier entity. Discounts at the upper level (a 25 percent noncontrolling interest holding entity) were still applied in the final decision.

As demonstrated in these judicial decisions, there exist appropriate situations to apply multilevel valuation discounts to multitiered entities. The understanding of the subject interest, the assets held by the tiered entities, the selection criteria and process for the selected discounts, and the overall support and conclusion of the selected discounts are each important attributes to the courts when determining the value of a multitiered subject interest.

Using judicial decisions as an initial framework of a court's viewpoint on certain multilevel valuation discount matters, engagement-specific considerations can be made.

Standard of Value and the Purpose of the Multitiered Entity Valuation

As in any valuation, the standard of value and the purpose of the valuation should be known and considered in the analysis. In multitiered entity valuations, the standard of value and the purpose of the valuation are particularly important.

The standard of value for many tax-related transfers is fair market value. Fair market value is typically defined as the price at which the subject property would change hands between a hypothetical willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

Judicial decisions frequently also state that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and the market for such property.[15]

Fair market value is an important standard of value in the case of multilevel entities. This is because it provides the base by which an analyst has the ability to value the separate tiers on an arm's-length, third-party basis. That is, the analyst may value the tiers on their independent levels of value, discussed in the following section.

Hjersted concluded that where the purpose of the valuation was to separate the estate's assets from the wife, the standard of value would be different. However, because the purpose of the valuation was for federal gift tax compliance purposes, the court ruled that fair market value was applicable. In the *Hjersted* case, the court ruled that multilevel discounts were applicable to the gift transfer.

The *Hjersted* case highlights that the purpose of the valuation analysis is also important to multilevel valuation discounts for multitiered entities. The purpose of the valuation analysis helps to determine the standard of value and, therefore, the level of value. If the purpose of the valuation is for sale, gift, or estate transfer compliance purposes, often the standard of value is fair market value and the multitiered entity will need consideration of multilevel discounts.

When valuing tiered ownership interests on the basis of fair market value, it is common to value the tiers at their respective fair market values. Valuing the tiered structure at each of its component tiers allows the analyst to more closely examine the inherent risks at each level. Therefore, the tiered interests are estimated in a manner that will more closely approximate the economic value of the ultimate subject interest.

Each Tier's Ownership Interest Level of Value

In order to apply multilevel valuation discounts to a tiered entity, the level of value of each tier must also be known. Level of value is defined as the basis at which commingled rights are held by the interest holder. For example, the level of value for a minority position in a large publicly traded company is often classified as a marketable, noncontrolling ownership interest level of value.

From a pure play valuation stand point, each tier should be valued at fair market value. For example, if the lower tier is a noncontrolling interest in real estate, such as in the *Astleford* case, the level of value of the lower tier would be a nonmarketable, noncontrolling ownership interest level of value. A discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) would be applicable. Then, the fair market value of the lower tier would be added as a component of the upper tier valuation.

If the upper tier holds the lower tier interest and other real estate properties, the economic or fair market value of each asset would be added to value the upper tier. Once the equity interest of the upper tier is known, the subject interest can be valued.

If the subject ownership interest is, for example, a 10 percent limited partnership interest, then it may be appropriate to consider a DLOC and DLOM at the upper tier level as well. In this example, multilevel discounts would be applicable.

Understanding the level of value provides further guidance to the appropriateness of multilevel valuation discounts. Some tiers may only be affected for blockage or market absorption, such as in *Dean*. The level of value would effectively be a nonmarketable, controlling interest, where the only discount would be for illiquidity of the specific asset.

In other cases, the level of value may be a nonmarketable, noncontrolling, nonvoting ownership interest. In such cases, discounts for lack of marketability, control, and voting rights may be applicable.

Conversely, in a case where the lower tier is effectively another direct asset of the upper tier, it may not be necessary to apply multilevel discounts. If a holding company owns 100 percent of a separate legal entity that owns a nonoperating parcel of land, the value may just be rolled up to the upper tier with no discounts or adjustments. The level of value aids in understanding the amount and appropriateness of multilevel valuation discounts.

Risks Associated with the Assets Held by the Tiered Entity

Discounts are used to measure the risk/uncertainties of achieving a required rate of return on one's investment. It is prudent to apply valuation discounts based on similar types of investments.

Some assets are inherently more risky than other types of investments, and, therefore, buyers typically negotiate a price lower than the net equity

value due to (1) risks associated with the underlying investment assets and (2) risks associated with the contractual arrangements made for the subject interest (discussed in the following section).

Creating a reasonable basis for selected valuation discounts may be achieved by comparing the subject investment to other similar investments in the public market, where buyers and sellers determine the price at which that investment is exchanged. For example, an entity that owns a mix of publicly traded securities may be compared to similar general equity closed-end funds, as may be found in *Barron's*.

An entity that operates an apartment complex may be compared to similar real estate investment trusts (REITs), such as those published in *Direct Investment Spectrum*. Discounts to an entity's equity base may vary based on the risks associated with the underlying assets. Investors are typically subject to greater risks as a noncontrolling owner in a joint venture real estate development project, for instance, than as a noncontrolling interest owner of a diversified investment portfolio.

Some risk factors associated with the assets held by the investment interests of a tiered entity include, but are not limited to, the following:

- Interrelationship factors—The interconnectedness of tiered entities can increase the discounts at the tiered levels. Entities that rely on each other to adequately function, whether it be from an operational perspective or lending perspective, can become less marketable investments and more risky to assume by a hypothetical willing buyer. Thus, discounts may be greater for entities that can't survive apart.
- Asset diversification—The greater the diversification, the lower the discounts, as lower business risk is associated with adequate diversification. Upper tier holding entities with multiple lower tier investments would garner lower discounts than an upper tier holding company with a few tier investment assets.
- Financial condition—Lower cash flows, limited liquidity, and highly leveraged entities often trade at a greater discount than entities with greater, more stable cash flow, ease of liquidity, and low amounts of leverage. Tiered structures with better financial conditions at some or all of the tiers, all else equal, have lower tiered discounts.
- Time horizon—The longer the marketing and holding period for the subject assets, the larger the discount at the ownership levels, as investors require additional returns for bearing the uncertainties of illiquidity risks. Lower tiered investments that are highly illiquid would require greater discounts to more closely estimate the value determined between buyers and sellers.
- Volatility—The lower the volatility of the market prices and cash flow of the assets, the lower the risks and, therefore, the lower the discounts. Tiered structures with investments that offset or significantly lower volatility for the subject interest holder would make a more attractive investment than an entity with highly concentrated and variable cash flow.

Risks Associated with the Contractual Restrictions of Tiered Ownership Interests

In addition to the assets held by the tiered entity, the contractual restrictions of the tiered ownership interests must be considered. Subject investments for many types of entities restrict the degree of influence on operations. For example, limited partners of a limited partnership may be passive investors, holding little to no voting rights or control prerogatives, which is often exclusively held by the general partner or partners.

The entity's operating agreement, bylaws, or other legal agreements may delineate the subject investor's contractual rights and limitations. These legally binding contractual arrangements may affect the discounts of tiered ownership interests.

Some contractual restrictions of tiered ownership interests include, but are not limited to, the following:

- Interim distributions and allocations of profit, loss, and liquidation proceeds—In some tiered ownership interest structures, the cash generating tiers may help to support the development of emergent tiers. Interest holders with control prerogatives will oftentimes decide how interim distributions, profit, loss, and liquidation proceeds are used.
- Management responsibilities—Limitations on management prerogatives based on contractual provisions at the lower tiers and upper tiers increase discounts to the subject investment interests. Having management control of all or a majority of the tiers is more attractive than a structure with little to no management control over the investment tiers.

- Transferability—If the subject investments are restricted by transfer provisions, valuation discounts may be greater. Within interrelated tiered structures, transferability to third parties may be difficult or impossible. For example, where bank financing is in place to support the lower tier investment assets, one covenant may stipulate that the bank must approve transfers of the collateralized holders of the financed entity. In some cases, bank restrictions may prohibit the sale of an owner's interest to another party without the loan becoming immediately due.

Tiered investment interests may be considered not only as stand-alone investments, but also as interrelated investments. The economic effect of being twice removed from the management of the assets themselves may make the subject interest an unattractive investment.

In many cases, valuation discounts for tiered entities may be substantial. This is because the pool of potential buyers that wish to accept all the unique characteristics of the tiered structure is minuscule. Often, a very similar, more attractive investment could be recreated where the contractual restrictions on the investor would not exist.

Avoiding the Effects of Double Discounting

One of the most important considerations in applying multilevel valuation discounts is to avoid the effect of double discounting. Double discounting involves applying multiple valuation discounts to the same risk factors for the same investment.

Discounting the lower tier for lack of unique buyers of an ownership interest in a remote non-income-producing property and then applying another valuation discount at the upper tier for the same risk factor would be inappropriate for the same investment risks. Since unique ownership risks exist at each level of ownership, the specific ownership interest risk factors should be used as the basis for the applied discounts, not a build-up of the same considerations.

For this reason, in many multitiered entities where the upper tier exists as a holding company for the interest in the lower tier's investment assets, the upper tier discounts may be incremental to the discounts applied at the lower tier.

The upper tier valuation discounts apply more to the subject interest's rights provided under the entity's agreements and the other assets and liabilities held by the upper tier. The effect of double discounting may be minimized by the effective pyramid discounting approach.

A pyramid discounting approach to valuation discounts of multilevel entities is sometimes used. Thinking of the application of tiered discounts as a pyramid of discounts (i.e., discounts that get smaller as you go up the entity structure) may be helpful in terms of avoiding double discounting.

For example, if the upper tier entity acts as a holding company of noncontrolling interests in lower tier real estate holding entities, the upper tier may have lower valuation discounts than the lower tiers. That is the tiered discounts once applied to the ownership interests begin to reflect a pyramid. Again, the idea is to apply discounts that mirror the risks to the interest holder of the equity ownership, both from legal contractual arrangements and from the assets held by the tiered entity.

If the lower tier is a risky real estate development entity and the upper tier is effectively an investment portfolio entity, greater discounts may apply at the lower tier than at the upper tier. The effects of double discounting may be negated if the risks subject to each interest at the lower tier and the upper tier are considered separately.

If the same risk element is accounted for in the lower tier and then again in the higher tier, double discounting may occur. Considering tiered discounts from the approach of a pyramid, building incremental discounts up to the ultimate valuation subject interest, may mitigate double discounting effects.

In some situations, the lower tier's discounted value may be excluded from the discounts applied at the upper tier entity. This procedure would effectively be a top-down procedure (applying valuation discounts only at the top tier). However, assigning specific discounts at each tier should not be duplicative.

Most multilevel valuation discounts apply a bottom-up procedure. Therefore, careful consideration should be made by the valuation analyst that double discounting does not occur.

The total valuation discount applied to the subject interest can be determined by (1) determining the discounted value of the subject interest, then (2) determining the undiscounted value of the subject interest, then (3) dividing the discounted value by the undiscounted value and subtracting one. The indicated percentage implies the total valuation discount applied against the assets owned indirectly by the subject interest holder.

Unjustifiably high implied total discounts may indicate double discounting. The analyst would then reconsider the magnitude of the tiered discounts, making sure the concluded value makes sense between a willing buyer and willing seller negotiating at arm's-length, or as the standard of value and the purpose of the valuation may dictate.

Reasonableness of the Discounts Applied and the Value Conclusion

For tax-related transfers, multitiered entities may provide apparent economic benefits. However, reasonableness of the valuation discounts applied should trump the strategic assemblage of tiered entity structures.

The analyst should be able to demonstrate that the selected tiered discounts and overall conclusion coincide with the standard of value, purpose of the valuation, and level of value of the tiers. When possible, the discounts applied should be supported by market evidence, whether directly or indirectly, and supported by the contractual agreements to the subject interest holder.

For most fair market value valuations, the value conclusion and implied overall discount to the undiscounted equity value should be representative of negotiations between hypothetical willing buyers and sellers, with both having reasonable knowledge of all relevant facts, and neither party being under any compulsion to buy or sell.

After final review of the value conclusion, if the value is not supported by market pricing evidence, then it may not be accepted by the courts either, as evidenced by some of the previously mentioned judicial decisions.

Summary and Conclusion

The gift, estate, or generation-skipping tax valuation of complex, multitiered business interests often involves multilevel valuation discounts. The reasonableness, support, and application of multilevel discounts at each tier play a role in valuing subject interests of tiered entities.

This discussion summarized seven considerations in the valuation of multitiered ownership structures. Understanding that each multitiered entity is unique provides some flexibility to the valuation analyst.

Prudence, support, and reflection on the value conclusion of multitiered business interest valuations can benefit the client by avoiding unnecessary audits and future court proceedings.

Notes:

1. Astleford v. Commissioner, T.C. Memo 2008-128 (May 5, 2008).
2. Paulina Du Pont Dean and J. Simpson Dean v. Commissioner, T.C. Memo 1960-54 (Mar. 28, 1960).
3. Edwin A. Gallun v. Commissioner, T.C. Memo 1974-284 (Nov. 6, 1974).
4. Gow v. Commissioner, T.C. Memo 2000-93 (Mar. 20, 2000), *aff'd* 19 Fed.Appx. 90 (4th Cir. 2001).
5. Estate of Hjersted, 175 P.3d 810 (Kan. 2008).
6. Kosman v. Commissioner, T.C. Memo 1996-112 (Mar. 11, 1996).
7. Estate of William T. Piper Sr. v. Commissioner, 72 T.C. 1062 (1979).
8. Whittemore v. Fitzpatrick, 127 F.Supp. 710 (D. Conn. 1954).
9. Roy O. Martin, Jr., and Barbara M. Martin v. Commissioner, T.C. Memo 1985-424 (Aug. 14, 1985).
10. Janda v. Commissioner, T.C. Memo 2001-24 (Feb. 2, 2001).
11. Estate of J.E. O'Connell v. Commissioner, T.C. Memo 1978-191 (May 25, 1978), *aff'd* on this point, *rev'd* on other issues 640 F.2d 249 (9th Cir. 1981).
12. The Ringgold Telephone Company v. Commissioner, T.C. Memo 2010-103 (May 10, 2010).
13. James G. Rabe, "Multilevel Discounts for Tiered Entities—Insights from Historical Case Law," *ACTEC Journal* (Fall 2009): 136–158.
14. James G. Rabe, "Subsequent Events and Multilevel Valuation Discounts—Ringgold Telephone Company v. Commissioner," *Insights* (Autumn 2010): 70–77.
15. Rev. Rul. 59-60, 1959-1 C.B. 237, Section 2.

Weston C. Kirk is an associate of our Atlanta office. Weston can be reached at (404) 475-2308 or at wckirk@willamette.com.