The Identification and Quantification of Valuation Adjustments in Closely Held Business or Security Valuations for Gift Tax or Estate Tax Purposes

Valuation analysts ("analysts") are often asked to value closely held businesses and business ownership interests (including debt and equity securities) for federal gift tax, estate tax, and generation-skipping transfer tax purposes. These business-related valuation analyses may be performed for tax planning, tax compliance, and/or tax controversy purposes. In the process of conducting the business valuation analysis, analysts often have to apply valuation adjustments to preliminary value indications—in order to reach final value conclusions and opinions. The type of—and the magnitude of—these valuation adjustments may vary depending upon which generally accepted business valuation approaches and methods the analyst applied as part of the business valuation process. As will be summarized in this discussion, there are many types of valuation adjustments that the analyst may have to consider. Typically, all of these valuation adjustments can be grouped into one of two categories: systematic adjustments and nonsystematic adjustments. Systematic and nonsystematic valuation adjustments can be either decremental (called valuation discounts) or incremental (called valuation premiums). Systematic adjustments are discounts or premiums that affect business and security valuations across the board—such as the so-called "level of value" adjustments. Nonsystematic adjustments are discounts or premiums that relate to an individual subject company or subject security—such as key customer dependence or specific buy/sell shareholder agreement transferability restrictions. This discussion explains the common procedures that analysts apply to identify the factors or conditions for a nonsystematic valuation adjustment in a business or security valuation performed for tax planning, compliance, or controversy purposes. This discussion explains the common procedures that analysts apply to quantify nonsystematic valuation adjustments. This discussion includes several simplified illustrative examples of business valuation adjustment analysis. And, finally, this discussion considers the appropriate sequencing of nonsystematic valuation adjustments in a business or security valuation performed for tax planning, compliance, or controversy purposes.

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Introduction

The application of valuation adjustments is a common procedure in the development of a closely held business and/or security valuation performed for federal gift tax, estate tax, or generation-skipping transfer tax purposes.

Valuation adjustments can be either valuation discounts (decremental—or value decreasing—adjustments) or valuation premiums (incremental—or value increasing—adjustments). There are "level of value" valuation adjustments that valuation analysts ("analysts") routinely consider in many taxation-related business and security valuation assignments.

These so-called level of value adjustment considerations include the following:

1. The degree of ownership control or lack of control of the subject or business ownership interest
2. The degree of marketability or lack of marketability of the subject business or business ownership interest

The analyst's consideration of such level of value adjustments is a common analytical procedure in a closely held business or security valuation. This is because the various generally accepted business valuation approaches and methods typically conclude different levels of value.

These type of level of value valuation adjustments are typically called systematic adjustments. These systematic valuation adjustments typically apply (1) across various industries and (2) across various company types and sizes.

The application of systematic valuation adjustments is influenced by the following:

1. The legal/economic characteristics of the subject business security, or business ownership interest (e.g., does the subject ownership interest represent target company operational or other ownership control of the closely held company or not?)
2. The selected and appropriate standard of value (e.g., fair market value, fair value, investment value, etc.)
3. The selected and appropriate premise of value (e.g., which alternative premise of value represents the highest and best use of the subject closely held business or security?)

This discussion summarizes these systematic (or level of value) adjustments in order to contrast such adjustments with nonsystematic valuation adjustments. This discussion primarily focuses on the identification of—and quantification of—nonsystematic valuation adjustments.

As the name implies, these nonsystematic valuation adjustments do not apply across the board to all business ownership interests of the same level of value. While nonsystematic adjustments should be considered in all tax-related business or security valuations, they are typically applied less often.

Categories of Nonsystematic Valuation Adjustments

Nonsystematic valuation adjustments typically fall into the following four categories:

1. Company-specific adjustments
2. Security-specific adjustments
3. Contract-imposed adjustments
4. Multitier adjustments

These four categories of valuation adjustments are described in greater detail later in this discussion. As an introductory explanation, these adjustments relate to some factors that are specific to the individual valuation subject (e.g., the subject block of securities) that would cause the analyst to apply a valuation discount or premium.

One example of a company-specific valuation adjustment may be key customer dependence. For example, let's assume that 90 percent of the annual revenue of a subject industrial/commercial company comes from one retail chain customer. That subject company suffers from key customer dependence. And, the valuation of that company should reflect that dependence risk.

One example of a security-specific valuation adjustment may be supervoting rights. For example, let's assume that the valuation subject is the Class B common stock that enjoys 100 votes per share, compared to the one vote per share enjoyed by the subject company's Class A common stock. That Class B common stock benefits from these supervoting privileges. And, the valuation of that Class B stock should reflect that benefit.

One example of a contract-imposed adjustment may be if the subject block of stock is subject to a shareholder agreement. For example, let's assume that the shareholder agreement allows the company to call the subject stock at any time at a call price that is equal to its accounting net book value. That contractual call option will affect the value of the subject block of stock.

One example of a multitier adjustment may be a family limited partnership ("FLP") interest that owns the remaining nonmarketable, noncontrolling stock of a closely held corporation. An analyst may apply a multitier adjustment when the subject corporation owns a substantial amount of liquid assets but neither (1) the subject FLP interest nor (2) the subject closely held stock interest has the right to demand an income distribution or asset liquidation. This illustrative FLP ownership interest suffers from both a lack of ownership control and a lack of marketability.

These illustrative nonsystematic valuation adjustments do not relate to the level of value of the subject business ownership interest or security. And, these illustrative adjustments do not apply across a broad range of valuation subjects. Rather, the application of nonsystematic valuation adjustments is specific to the facts and circumstances of each individual tax-related business valuation subject.

In contrast, while the quantification of nonsystematic adjustments is unique to each individual valuation subject, systematic valuation discounts and premiums are common across a broad range of tax-related business valuation subjects.

This discussion concludes with a summary of general analyst caveats related to the identification and quantification of nonsystematic valuation adjustments in closely held business and security valuation analyses. Analysts (and taxpayers and tax counsel) should consider these general analyst caveats with regard to a business or security valuation prepared for tax planning, compliance, or controversy purposes.

Analyst Considerations regarding Valuation Adjustments

Adjustments Are Not Made from a Value Conclusion—But Rather to Conclude a Value

First, both systematic and nonsystematic valuation adjustments are always made in order to reach a conclusion of value. Valuation adjustments (i.e., systematic or nonsystematic adjustments) are not made from a conclusion of value.

Inexperienced valuation analysts are often confused by this important distinction. Inexperienced analysts believe that the analyst first reaches a conclusion of the correct value for the subject business ownership interest. Then, inexperienced analysts erroneously believe that the analyst applies a discount or premium to the concluded value in order to arrive at a discounted value—or an inflated value.

This misconception is both procedurally and conceptually incorrect. In contrast, analysts actually apply valuation methods to arrive at value indications. Each generally accepted business or security valuation method involves numerous analytical procedures.

The various generally accepted business valuation methods provide preliminary indications of value—until all of the requisite procedures are performed. And, one of the requisite procedures in all generally accepted business valuation methods is to consider (and apply, when appropriate) valuation discounts and premiums.

So, valuation adjustments are applied to a preliminary value indication in order to arrive at a final value conclusion. Valuation adjustments are not applied to a final value conclusion—to arrive at either a discounted value conclusion or an inflated value conclusion.

Implicit Adjustments versus Explicit Adjustments

Second, regarding both systematic and nonsystematic adjustments, the application of valuation adjustments—and the magnitude of the valuation adjustments—may vary based on each valuation approach and method.

There are two components to this analyst consideration:

1. Implicit level of value, systematic adjustments
2. Implicit/explicit quantification of nonsystematic adjustments

Some generally accepted business valuation approaches and methods typically provide a certain indicated level of value. For example, the market approach/guideline publicly traded company method typically arrives at a marketable, noncontrolling ownership interest level of value.

Typically, the asset-based approach/asset accumulation method arrives at a marketable, controlling ownership interest level of value.

Typically, the income approach/discounted cash flow method can arrive at either a controlling or a noncontrolling ownership interest level of value. The indicated level of value depends on the individual valuation variables selected for both (1) the cash

flow projection and (2) the present value discount rate.

In each of these instances, the application of a systematic, level of value valuation adjustment will depend on both:

1. the level of value typically indicated by the selected valuation approach and method and
2. the individual valuation variables used in the specific application of that business valuation method.

Therefore, within the same tax planning, compliance, or controversy valuation assignment, systematic adjustments may apply to some valuation approaches and methods—but not to others. And, depending on the individual valuation variables used within the particular business valuation method, different magnitudes of the same valuation adjustment (e.g., the discount for lack of marketability) may apply between the different valuation approaches and methods applied.

Regarding nonsystematic valuation adjustments, sometimes the analyst may make an adjustment implicitly within an individual valuation method analysis. And, sometimes, the analyst may apply an explicit adjustment to the value indication concluded by the individual valuation method.

For example, let's consider a discount for key person dependence. The key person could be the chief executive officer, chief marketing officer, chief design engineer, or any other senior—and strategically important—executive. If the analyst uses the income approach/discounted cash flow method, the analyst could quantify a key person dependence discount either implicitly or explicitly.

Implicitly, the analyst could adjust the cash flow projection for the cost to recruit, hire, train, and maintain a hypothetical replacement executive (e.g., a first lieutenant for the key executive).

Explicitly, the analyst could arrive at an unaffected preliminary business enterprise value indication—and then subtract either a discrete percentage discount or a discrete dollar discount (for the key person dependence) from the preliminary value indication.

As another example, let's consider a discount for lack of voting rights related to the valuation of the class B nonvoting common stock (e.g., a class of stock retained by the founding family). Again, the analyst may quantify this valuation adjustment either implicitly or explicitly.

If the analyst uses the market approach/guideline publicly traded company method, the valuation adjustment could be made within the analytical procedures—to arrive at an implicitly discounted value indication. Or, the valuation procedures could be performed on unaffected basis, and the preliminary value indication could be explicitly adjusted for the discount.

Implicitly, the analyst could compare the multiples of relevant guideline companies that have supervoting shares to the multiples of the same company's shares with lower voting rights and recognize that relationship when selecting multiples to apply to the subject company. The application of such pricing multiples would arrive at a final value indication that is implicitly affected by a lack of voting rights.

Alternatively, the analyst could select voting guideline company stocks from which to extract market-derived valuation pricing multiples. The application of such valuation pricing multiples would arrive at a preliminary value indication that would need to be explicitly adjusted by a percentage discount for lack of voting rights.

Standard of Value Influences

Third, regarding both systematic and nonsystematic adjustments, the application of adjustments is directly affected by the standard (or the definition) of value sought in the gift-tax-related and estate-tax-

related business or stock valuation. If the assignment standard of value is fair market value (as is the case with tax-related business valuations), then most valuation adjustments will typically apply.

This is because the marketplace of willing buyers and willing sellers will generally recognize all valuation discounts and premiums.

However, if the assignment standard of value is fair value (as is typically the case with regard to statutory dissenting shareholder appraisal rights matters or shareholder oppression matters), then certain systematic, level of value adjustments may not be considered.

In many situations (as required either by statute or by judicial precedent), fair value is synonymous with pro rata business enterprise value. This pro rata business enterprise analysis concludes a value that is legally "fair" to all parties to the subject shareholder rights litigation.

That is, business enterprise value is the level of value where all shares of stock in the subject company have the same value per share. This is true regardless of whether the shares are owned by a 90 percent controlling stockholder or by a 10 percent noncontrolling stockholder. At the business enterprise level of value, the one stockholder receives no economic reward for either squeezing out or oppressing another stockholder.

For example, under this interpretation of fair value, the controlling stockholder is not allowed to pay a "discounted" price of $10 per share to the noncontrolling stockholder for shares that are worth $20 per share to that controlling stockholder.

Therefore, in many fair value business valuation assignments, certain valuation adjustments are usually not applicable—even if the subject block of stock is a nonmarketable, noncontrolling ownership interest.

The valuation principles that support this level of value in a fair value analysis are often called "the economics of fairness."

Similarly, let's consider the example of an investment value (or owner value) assignment. In such an assignment, the analyst may not apply a nonsystematic discount for a suboptimal product distribution function at the subject company.

If the current corporate owner wants to quantify the value to itself (given its specific corporate investment criteria) of a certain subsidiary, a discount for the lack of a distribution function may not be relevant. Let's assume that the corporate parent is a company like Pfizer—that is, a multinational pharmaceutical company that is recognized for its world class product distribution function.

Let's assume that the current corporate parent operates the subject company as a manufacturing subsidiary that effectively sells all of its production to a market/distribution subsidiary. For an investment value analysis, the lack of the subject company's distribution system would not represent a value penalty to the current owner. Therefore, the analyst may not apply a nonsystematic lack of distribution function discount in an investment value analysis for a Pfizer-like corporate owner.

As another example, let's assume an acquisition value transactional assignment for a corporate acquirer. Let's assume that the subject target company clearly suffers from key person dependence. Let's assume that the target company founder is a key person who will retire at the time that the company is acquired.

The potential acquirer is a large, publicly traded corporation that has several tiers of mid-level executives who are qualified to (and waiting for the opportunity to) manage a company the size of the target company.

The acquisition value standard of value indicates what a specific buyer would be willing to pay to a specific seller for the subject business interest.

The analyst may decide not to apply a nonsystematic key person dependence discount in the acquisition value assignment for this particular acquirer given (1) the acquisition value standard of value and (2) the fact that the target company key person dependence does not represent a deficiency to the specific corporate acquirer.

Nonsystematic Valuation Adjustments

Something that is nonsystematic is not orderly, regular, or consistent. Nonsystematic valuation adjustments are discounts or premiums that should be considered—but are not necessarily applied—in all business or security valuations. Rather, nonsystematic adjustments are specific to the individual facts and circumstances of a particular valuation subject business or security ownership interest.

Nonsystematic valuation adjustments generally are grouped into the following four categories:

1. Company-specific
2. Security-specific
3. Contract-specific
4. Multitier

Each of these four categories of nonsystematic valuation adjustments is discussed below.

Company-Specific Valuation Adjustments

Company-specific valuation adjustments relate to facts and circumstances that are specific to the subject business or security. Some common examples of company-specific valuation adjustments include the following:

1. Discount for key person dependence
2. Discount for key customer dependence
3. Discount for key supplier dependence
4. Discount for key product/technology dependence
5. Discount for suboptimal capital structure
6. Discount for suboptimal cost of capital

These company-specific valuation factors can be either controllable or noncontrollable. That is, some of these factors can be controlled (or eliminated) due to the actions of the company management. For example, to eliminate interest rate fluctuation risk, the subject company management could decide to employ a 100 percent equity capital structure.

As an example of an uncontrollable risk factor, let's assume that there may be only one domestic supplier for the company's key medicinal chemicals component. In that case, management's reliance on the key supplier is an example of an uncontrollable decision.

In any event, all of these company-specific factors first affect the company valuation at the business enterprise level. These company-specific risk factors are not related to the level of value of an individual shareholder's subject ownership interest. And, these risk factors typically do not affect one class of company security at the expense of another class of company security.

Each of the risk factors in this category makes the subject company different (from an investment risk and/or expected return perspective) from the typical company in the subject industry or the subject peer group. Accordingly, this category of valuation adjustment is typically made at the company (invested capital or total equity) level.

Security-Specific Valuation Adjustments

Security-specific valuation adjustments relate to facts and circumstances that are specific to the subject security interest or the subject block of stock.

Some common examples of security-specific valuation adjustments include the following:

1. Discount for lack of voting rights
2. Premium for supervoting rights
3. Blockage discount
4. Discount for lack of preemptive rights

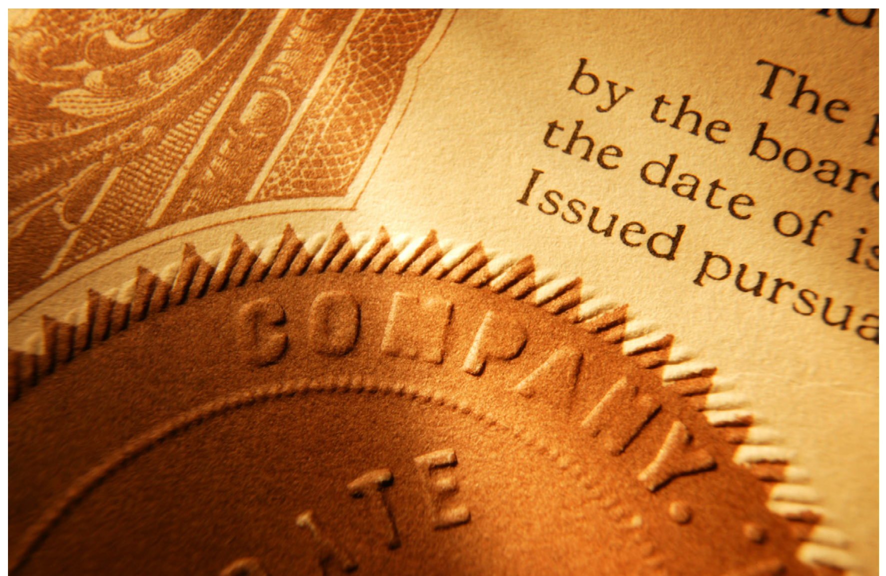
All of these security-specific risk factors first affect the valuation at either:

1. the class of security level (e.g., a discount for lack of voting rights may be applied to all of the nonvoting common stock) or
2. the specific subject security level (e.g., a blockage discount may be applied to a 25 percent block of stock in an inactively traded public company).

And, each of the security-specific risk factors in this category makes the subject security interest different (from an investment risk and/or expected return perspective) from either:

1. the typical security in the subject company or
2. a guideline or benchmark security used for comparative pricing purposes.

In any event, this category of valuation adjustment is typically applied at the subject security level (e.g., at the per share of stock level) and not at the total business enterprise level.



Contract-Specific Valuation Adjustments

Contract-specific valuation adjustments relate to facts and circumstances that are imposed on the subject security by the influences of a contract, agreement, regulation, or covenant. Some common examples of contract-specific valuation adjustments include the following:

1. Stock that is subject to the buy-sell provisions of a shareholder agreement
2. Restricted publicly traded stock
3. Founder, letter, or other unlisted stock of a listed public company
4. Partnership units subject to a partnership agreement and limited liability company ("LLC") member units subject to an LLC member agreement

All of these factors affect the valuation of the specific subject ownership interest as the result of an exogenous influence. That exogenous influence is the result of a particular ownership interest being subject to the terms and conditions of some type of contract or agreement. These types of contract-specific restrictions are common in the case of equity that is owned by a private equity investor.

The contract terms may involve put, call, transfer, or ownership restrictions of a stockholder, LLC, or FLP agreement. The contract terms may affect the income distribution or the asset liquidation proceeds rights of the subject ownership interest.

In some cases, the contract terms may positively enhance the transferability of the subject ownership interest—such as the put option on ESOP-owned sponsor company common stock that is a contractual condition of ESOP trust agreements.

The exogenous influence may be the result of an employment agreement. Such an employment agreement may prohibit the company executive from selling the subject stock:

1. while he or she remains an employee of the company or
2. for a specified number of years.

The exogenous influence may be the result of (1) an agreement with security underwriters or (2) a requirement of the Securities Exchange Commission ("SEC") or of the stock exchange. Unlisted shares of stock of a publicly traded company (e.g., founder stock, letter or legend stock, or stock subject to SEC Rule 144) are typically subject to contractual and/or regulatory transferability restrictions.

Each of the factors in this category makes the subject business ownership interest different (from an investment risk and/or expected return perspective) from either:

1. the typical security of the subject company that is not subject to the contractual/regulatory influence or
2. a guideline or benchmark security used for comparative pricing purposes.

In any event, this category of valuation adjustment is typically applied at the subject ownership interest level (e.g., to the particular block of stock or other equity units).

Multitier Valuation Adjustments

Multitier valuation adjustments relate to facts and circumstances that are specific to the ownership structure of the subject security interest. Some common examples of multitier valuation adjustments include the following:

1. Closely held corporation ("CHC") stock owned by an FLP
2. Nonconsolidated CHC stock owned by another CHC
3. Any multitier ownership where a distribution will trigger the recognition of capital gains
4. A fractional or partial property ownership interest inside a CHC or FLP

Multitier valuation adjustments are sometimes referred to as inside/outside valuation adjustments. In the typical instance, asset A is owned by asset B, which may itself be owned by asset C. In this example, asset C is the valuation subject.

Typically, in order to receive income distributions, the owner of asset C must first liquidate assets A and B. Accordingly, there is a series of security-specific and/or contract-specific adjustments that should be applied in the valuation of the multitier ownership interest.

In the valuation of a multitier ownership interest, questions arise not only as to the magnitude of the appropriate valuation adjustments. Questions also arise as to the sequencing (and relative magnitude) of the appropriate valuation adjustments.

Typically, the lower level/inside adjustments are applied first, and the higher level/outside adjustments are applied second. That is, first adjustments are applied to asset A, and then an asset A cash equivalency value is estimated.

Then, second, adjustments are applied to asset B, and then an asset B cash equivalency value is estimated.

Finally, adjustments are applied to asset C, and then an asset C value is concluded.

Systematic Valuation Adjustments

Systematic events typically affect a broad population and occur with some regularity and order. This statement is also true of systematic valuation adjustments. These adjustments affect a broad range of valuation assignments. And, the analyst's application of systematic valuation adjustments occurs with regularity.

In fact, depending on the valuation approaches and methods used, virtually all closely held company business or security valuations involve either implicit or explicit systematic valuation adjustments. Accordingly, the analyst should consider the appropriateness of systematic valuation adjustments in most closely held company business or security valuations.

Although the category of systematic adjustments is not limited to level of value adjustments, these adjustments are a common type of systematic adjustment. There are two reasons for this. First, virtually every business or security valuation assignment involves a specified level of value. And, second, alternative valuation approaches and methods typically produce value indications at different levels of value.

Therefore, if the analysis involves two or more valuation approaches and methods, the analyst may have to apply some systematic adjustment in order to conform all of the value indications to the same level of value.

Typically, all value indications should be stated on the same level of value (typically, the level of value consistent with the valuation assignment) before a meaningful valuation synthesis and conclusion is reached.

Some of the common systematic valuation adjustments include the following:

1. Discount for lack of marketability (related to an ownership interest that is less than the total closely held business enterprise)
2. Discount for illiquidity (related to the analysis of the overall closely held business enterprise)
3. Discount for lack of ownership/operational control
4. Premium for ownership/operational control
5. Premium for strategic/synergistic benefits

The above-listed systematic adjustments relate to the level of value of the subject ownership interest. Many inexperienced analysts believe that there are only three or four discrete levels of value.

In fact, there is a virtually continuous spectrum of levels of value. And, the continuous spectrum itself typically has two axes:

1. Ownership control elements
2. Marketability elements

There is a broad spectrum of value influences ranging from:

1. absolute ownership/operational control with immediate synergistic opportunities to
2. absolute lack of ownership/operational control.

For example, an owner of a 30 percent block of closely held company stock may have significant elements of operational control if there are 70 other unrelated stockholders, each of whom owns only one percent of the closely held company stock. As another example, the owner of a two percent block of closely held company stock can experience the swing vote value influences of control if there are two other unrelated stockholders, each of whom owns 49 percent of the closely held company stock.

The owner of 51 percent of a closely held company stock usually has one level of ownership control. The value of that block of stock would likely enjoy some level of control premium. However, in many states, a two-thirds vote is legally required for many corporate "control events" (e.g., a corporate liquidation or a sale of substantially all of the company assets).

Therefore, the owner of a 67 percent block of stock may enjoy a greater control premium than the owner of a 51 percent block of stock.

Likewise, the ownership of 80 percent of a closely held company is required to consolidate a subsidiary for both financial accounting and income tax reporting purposes. That's why many acquirers won't pursue a target company unless they are sure of owning at least 80 percent of that company's stock.

Therefore, the owner of an 80 percent block of stock may enjoy a greater control premium than the owner of a 79 percent block of stock.

The owner of a 95 percent block of closely held company stock still has fiduciary obligations to the company's noncontrolling stockholders. The elimination of noncontrolling stockholders eliminates both this fiduciary duty and the possibility of nuisance litigation claims from dissenting noncontrolling stockholders.

Therefore, the owner of a 100 percent block of closely held company stock may enjoy a greater control premium than the owner of a 95 percent block of stock.

There is also a continuous spectrum of value influences with regard to marketability elements. This broad spectrum of value influences ranges from:

1. absolute liquidity (equivalent to that enjoyed by actively traded stock listed on a public stock exchange) to
2. virtually absolute illiquidity (imposed by FLP, stockholder, buy/sell agreement, or by an other contract/agreement that restricts transfer, limits potential buyers, and dictates sale price).

The multitier ownership structure of the subject security (e.g., a security owned by an entity that is owned by another entity) may also have marketability implications that influence value.

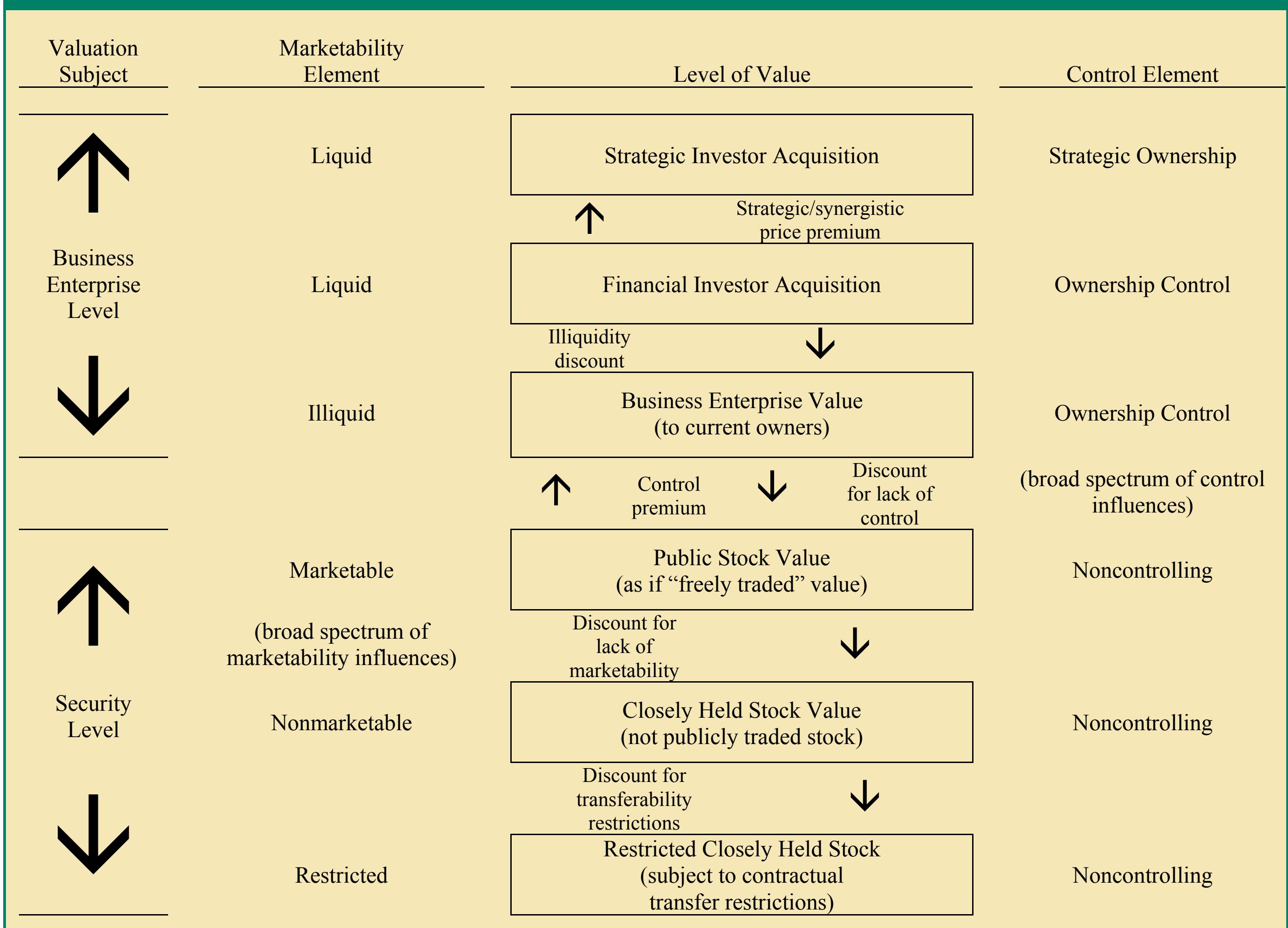
While it may be impossible for analysts to conceptualize all of the discrete steps along the control/marketability continuum, these two elements really represent a continuous spectrum of combined valuation adjustment possibilities.

However, for visualization and illustrative purposes only, Figure 1 represents several of the common levels of value with regard to a closely held business or security valuation. Where applicable, Figure 1 also presents simplified indications of the valuation discount/premium relationships among the common levels of value.

Nonsystematic valuation discounts and premiums may be quantified as either:

1. a percentage adjustment or
2. a dollar amount adjustment.

Figure 1
Closely Held Business or Security Systematic Valuation Adjustments
Simplified Illustration of the Common Levels of Value



When both percentage and dollar amount adjustments are appropriate, the analyst should carefully consider the appropriate sequence for applying the adjustments.

However, systematic valuation discounts and premiums (particularly level of value adjustments) are typically quantified as percentage adjustments. Therefore, if both control influence and marketability influence discounts/premiums are applied as percentage adjustments, then the mathematical sequencing of the application of systematic adjustments is often irrelevant.

That is, as long as they are all expressed on a percentage discount or premiums basis, the systematic valuation adjustments usually can be applied in any order.

Why Valuation Adjustments Are Important to the Business or Security Valuation Process

Experienced analysts understand that the concept of a valuation adjustment is meaningless without a clear answer to the question: adjustment to what? The analyst first has to understand the baseline or benchmark against which any valuation discount or premium is contemplated.

In other words, the application of any valuation discount or premium is fundamentally inappropriate unless the benchmark (against which the adjustment is compared) is clearly defined.

For example, it may be inappropriate to apply a discount for lack of marketability to a value indication that is already stated on a nonmarketable basis. Likewise, it may be inappropriate to apply an ownership control premium to a value indication that is already stated on a controlling ownership interest basis.

The first question for the analyst to ask with regard to a valuation adjustment is: What do I have? This question relates to what systematic and nonsystematic elements exist in the following:

1. The generally accepted business valuation approaches and methods selected
2. The individual valuation analysis variables selected
3. The guideline or other transactional data extracted
4. The valuation method value indications derived.

These elements (which either are present or are absent) represent the baseline or benchmark of the business or security valuation analysis.

The second question for the valuation analyst to ask with regard to a valuation adjustment is: What do I want? This question relates to what systematic and nonsystematic elements exist in:

1. the subject company and/or
2. the subject security/ownership interest.

In particular, the analyst is looking for operational, financial, contractual, and regulatory features of the subject company or security that are different from those of the benchmark analysis. These selected features should make the subject company or security different from the benchmark analysis from an investment risk/expected return perspective.

It may be obvious why the analyst should thoroughly understand the benchmark analysis first. At this point in the valuation, the benchmark analysis is what the analyst has. Ideally, the benchmark analysis should perfectly match the subject company or security from an investment risk/expected return perspective.

This is because an analysis of the subject company or security is what the analyst wants. If the elements in the benchmark analysis match up perfectly with the elements in the subject company or security, then no valuation adjustment is needed. Of course, that occurrence is rarely the case.

Therefore, the third question for the analyst to ask with regard to a valuation adjustment is: How is the subject company or security different from the benchmark analysis? When answering this question, the analyst should identify all of the systematic and nonsystematic elements in the valuation subject that are not in the benchmark analysis—and vice versa.

Finally, the fourth question for the analyst to ask with regard to a valuation adjustment is: How do I get to what I want from what I have? In other words, what transactional adjustments are needed to make the value indications/conclusions of the benchmark analysis more applicable to the valuation subject?

Alternatively, what valuation adjustments are needed to minimize the systematic and nonsystematic element differences between the benchmark analysis and the valuation subject?

It is noteworthy that this fourth question helps the analyst to identify valuation adjustments that make the investment risk/expected return features of the benchmark analysis look more like the

valuation subject. It is not the objective of valuation adjustments to make the investment risk/expected return features of the subject company or security look more like the benchmark analysis.

In summary, valuation adjustments are only applicable to make the benchmark or baseline analysis look more like the subject company or security from an investment risk/expected return perspective. Therefore, it is important that the analyst fully understand the systematic and nonsystematic elements of the benchmark analysis before any valuation adjustments are considered.

In addition, the selection of the valuation adjustments is influenced by the following:

1. The specific business valuation approaches, methods, and procedures performed
2. The purpose and the objectives of the analysis, including the standard of value and the premise of value that is appropriate for the individual valuation assignment

Illustrative Listing of Valuation Adjustments

Exhibit 1 presents a noncomprehensive listing of valuation discounts and premiums. Exhibit 1 does not distinguish between systematic (or level of value) adjustments and nonsystematic adjustments.

While Exhibit 1 is not intended to be comprehensive, it may provide a convenient valuation adjustment checklist or reminder list for the analyst who is performing a gift-tax-related or estate-tax-related business or security valuation.

Methods to Quantify Valuation Adjustments

There are numerous analytical procedures that are used to quantify individual valuation adjustments. When considered conceptually, all of these individual

Exhibit 1
Closely Held Business or Security Valuation Adjustments
Illustrative List of Common Valuation Discounts and Premiums

Valuation Discounts Related to:	Valuation Premiums Related to:
Assignee ownership interest	Ownership/operational control
Blockage (size) of public stock	Put options
Built-in capital gains taxes	Strategic/synergistic benefits
Call options	Superliquidation preference
Founder/letter/legend stock	Supervoting rights
Illiquidity (at business enterprise level)	
Key customer dependence	
Key person dependence	
Key supplier dependence	
Key technology dependence	
Lack of dividend rights	
Lack of marketability (at security level)	
Lack of ownership/operational control	
Lack of preemptive rights	
Lack of voting rights	
Multitier ownership structure	
Partial/fractional ownership interest	
Right of first refusal	
SEC Rule 144	
Suboptimal capital structure	
Suboptimal cost of capital	
Transferability restrictions (contractual)	
Unlisted stock of public company	

procedures are grouped into four categories of methods:

1. Comparative empirical data regarding the valuation subject
2. Comparative income data regarding the valuation subject
3. Published empirical data regarding valuation guidelines/benchmarks
4. Reliance on judicial/administrative guidance

Each of these four categories of methods is described below.

The first two above-listed methods use data extracted directly from the subject closely held company or security. If such data are available, then these methods provide valuation adjustment indications that are specifically derived from the valuation subject.

In the first method, the analyst compares the valuation subject to a benchmark or baseline that does not have the discount/premium value influence. Based on this comparison, the analyst extracts pricing metric data that are used to quantify the specific valuation adjustment.

In the second method, the analyst compares some measure of the valuation subject income to the same income measure, adjusted to exclude the effect of the valuation discount/premium. The capitalization of this income differential provides an indication of the appropriate amount of the valuation adjustment.

Using the comparative empirical data method, the analyst typically looks for comparative sales involving the subject security, where:

1. one sale doesn't have the particular discount/premium feature and
2. the otherwise comparable sale does have the particular discount/premium feature.

For example, let's assume that there were historical sale transactions involving two classes of the subject company stock: one class with voting rights and one class without voting rights. The analyst could examine these transactions and extract a discount for the lack of voting rights.

Likewise, let's assume that there were historical sale transactions involving (1) subject company stock that is subject to a right of first refusal and (2) otherwise comparable subject company stock that is not subject to a right of first refusal.

Again, the analyst could examine these transactions and extract a discount related to a contractual agreement right of first refusal.

Using the comparative income data method, the analyst typically identifies revenue, expense, or investment differences that are attributable to the particular discount/premium feature. The analyst attempts to quantify how the subject revenue, expenses, or investment would change if the particular discount/premium feature changes.

The analyst then capitalizes the expected income change over the remaining useful life (RUL) of the income change. The present value of the projected income difference provides an estimate of the amount of the valuation discount/premium.

For example, let's assume that Fred Founder is the controlling stockholder at Alpha Corporation, a closely held company. As the controlling stockholder, Fred Founder pays himself a salary that is $1 million per year greater than a reasonable salary level for a comparable executive at a comparable company. The analyst is attempting to quantify the ownership control premium associated with Founder's stock ownership interest.

The analyst could (1) isolate the economic benefit associated with Founder's ownership control (i.e., his excess compensation) and (2) capitalize that economic benefit at an appropriate capitalization rate. The capitalized excess compensation would be one indication of the amount of Founder's ownership control premium.

All of the procedures related to the empirical data and the empirical income methods ultimately involve three types of analyses:

1. An estimate of the income shortfall related to the valuation discount; estimate of the excess income related to the valuation premium
2. An estimate of the cost to cure the deficiency feature
3. A paired sales analysis of (a) transactions with the subject discount/premium feature and (b) transactions without the subject discount/premium feature

The empirical data and empirical income methods rely on income, cost, or sales data extracted from the subject company in order to quantify the systematic or nonsystematic valuation adjustment. The published empirical data method is a common method to quantify valuation discounts and premiums. It is also a commonly misused method.

"There are also numerous published studies with regard to nonsystematic valuation adjustments. . . ."

Many analysts rely on published studies of empirical data to derive level of value adjustments, such as a discount for lack of marketability or a premium for ownership control. There are also numerous published studies with regard to nonsystematic valuation adjustments as well, such as a discount for lack of voting rights.

Most published empirical studies rely on the paired sales analysis procedure. These empirical studies analyze:

1. one set of sale transactions that are not affected by the subject feature and
2. one set of sale transactions that are affected by the subject feature.

The percentage difference in transaction prices (or the percentage difference in transaction pricing multiples) provides an indication of the amount of the individual valuation discount or premium.

The difference in this third method (compared to the first two methods) is that both sides of the paired sales analysis comparison relate to guideline company/security transactions. In other words, none of the data analyzed in these published studies actually comes from the subject company/security.

This factor should not invalidate the use of this empirical/study method. The concern regarding the use of this valuation adjustment quantification method is not the data source. The concern is how the analyst relies on the published study results to select subject-specific valuation adjustments.

Often, analysts rely on published empirical studies to estimate valuation adjustments:

1. without understanding the procedural mechanics of the particular published study,
2. without understanding the type (e.g., industry, size, etc.) of transactions analyzed in the particular published study, and
3. without considering the time period of the particular published study (compared to the subject valuation date).

In addition, analysts sometimes select the mean or median conclusion from the published study as the appropriate valuation discount or premium in every business or security valuation. When this happens, the resulting analysis has not reflected the range of results indicated by published studies—such as the interquartile conclusions, the standard deviations, and the high/low observations.

And, the resulting analysis has not considered (qualitatively or quantitatively) exactly what valuation adjustment would be appropriate to the unique factors of the specific subject company or security—given the range of data reported in the published empirical study.

The fourth "method" for quantifying valuation adjustments considers published judicial precedent and administrative rulings (e.g., Internal Revenue Service ("Service") audit settlement agreements) for guidance. While this method is sometimes used by inexperienced analysts, it is not recommended by experienced analysts.

This so-called "method" does provide the analyst with very useful information as to the reasonable range of valuation discounts and premiums that courts and regulators have found acceptable. However, these data do not provide a particularly reliable source of information from which to select a specific valuation adjustment related to a specific business valuation.

Judicial precedent, Service letter rulings and settlement agreements, and other administrative rulings are always fact-specific. By definition, they only apply to the specific facts and circumstances of the matter and/or taxpayer to which they apply. They are not intended to provide general guidance with regard to the level of valuation discounts and premiums that is appropriate in other situations.

Published judicial decisions (and other rulings) are only applicable to the extent that the subject company or security facts and circumstances are identical to the published decision facts and circumstances. And, that is hardly ever the case.

Summary of Valuation Analyst Caveats

Exhibit 2 presents a nonexhaustive listing of caveats that analysts should consider with regard to the identification and quantification of valuation discounts and premiums for estate planning/estate tax valuations.

This summary of analyst caveats applies to each of the four above-described methods for quantifying valuation adjustments.

Exhibit 2
Closely Held Business or Security Valuation Adjustments
List of Analyst Caveats regarding Valuation Discounts and Premiums

1. Analysts should thoroughly understand the valuation analysis baseline or benchmark before applying any valuation adjustments.
2. Analysts should thoroughly understand the economic influences of the specific systematic or nonsystematic feature considered; that is, does it actually affect the investment risk and/or expected return of the subject closely held company or security?
3. Analysts should be careful not to "double count" valuation adjustments. For example, a valuation discount for the built-in gains tax may be a component of an overall discount for lack of marketability—and not a separate, discrete valuation adjustments.
4. When analysts use alternative procedures to quantify valuation adjustments (e.g., income shortfall/excess, cost to cure, paired sales analysis), the lower valuation adjustment indication is often an appropriate valuation adjustment conclusion.
5. Analysts should not solely rely on published judicial precedent as the basis of selecting specific valuation adjustments, unless the facts and circumstances in the subject valuation are identical to those considered in the published decision.
6. Analysts should be aware that not all business valuation methods/value indications may be subject to the same valuation adjustment—or to the same magnitude (either dollar amount or percentage) of valuation adjustment.
7. Analysts should recognize that the application of valuation adjustments is influenced by the purpose and the objective of the analysis (e.g., the assignment standard of value, the premise of value, etc.) as well as by the specific features of the subject closely held company or security.
8. Analysts should be sufficiently familiar with the content and intent of published empirical valuation adjustment studies before relying on such published studies as the basis of selecting a specific valuation discount or premium.
9. Analysts should carefully consider the time period covered in any published empirical valuation adjustment study before relying on that published study for use as of a specific valuation date.
10. Analysts should carefully consider the dispersion of the results reported in published empirical valuation adjustment studies. Valuation analysts should avoid the naive reliance on mean or median results of such published studies without considering whether such conclusions are applicable to the specific facts and circumstances of the subject closely held company or stock valuation.

Summary and Conclusion

This discussion focused on the identification and the quantification of nonsystematic and multi-tier valuation adjustments. This discussion also touched on the identification and quantification of systematic (e.g., level of value) valuation adjustments.

This discussion considered both when and why valuation adjustments are applicable in the valuation of closely held companies and securities for gift tax and estate tax purposes. This discussion presented an illustrative (but nonexhaustive) list of business or security valuation discounts and premiums that analysts may consider in valuations performed for tax planning, compliance, or controversy purposes.

In particular, this discussion presented (1) four common methods for quantifying valuation adjustments and (2) three common procedures for quantifying valuation adjustments. Comparative conceptual/practical strengths and weaknesses of the various valuation adjustment methods were discussed.

And, this discussion presented a nonexhaustive list of caveats that analysts should consider when selecting specific business/security valuation discounts and premiums for federal gift tax, estate tax, or generation-skipping transfer tax purposes.