Analyst Considerations in Applying a Discount for Lack of Control in Transfer Tax Valuations

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Valuation analysts ("analysts") often have to consider the issue of "level of value" in private company business and security valuations performed for either gift tax, estate tax, or generation-skipping transfer tax (collectively "transfer tax") purposes or income tax purposes. The level of value issue relates to the considerations of (1) marketability (or the lack of marketability) and (2) ownership control (or the lack of ownership control) related to the subject business ownership interest. These considerations are often incorporated into the private company valuation through the analyst's application of valuation adjustments. These valuation adjustments may be either valuation discounts (or value reductions) or valuation premiums (or value increases). This discussion focuses on analyst considerations with regard to applying a discount for lack of control in the valuation of a private company performed for either transfer tax or income tax purposes.

Introduction

Valuation analysts ("analysts") are often retained to value private companies, private company ownership interests, and private company securities for tax purposes. These tax purposes could involve gift tax, estate tax, and generation-skipping transfer tax (collectively referred to herein as "transfer tax").

Such transfer tax valuations could be performed for purposes of tax planning, tax compliance (including tax return preparation), Internal Revenue Service ("Service") audit support, and tax litigation (including testifying expert services).

To develop the transfer-tax-related valuation, the analyst has to understand the subject ownership interest, of course. That is, the analyst has to know if the valuation subject is the entire private company (whether a corporation, partnership, limited liability company, etc.), a particular ownership interest in the company (e.g., a 50 percent ownership interest), or a particular security in the company (e.g., 1,000 shares of Class B nonvoting common stock).

The analyst has to know the legal ownership interest subject to valuation. That is, the analyst should be instructed as to whether the valuation subject should be valued in fee simple interest—or as a term interest, a reversionary interest, or some other limited bundle of legal rights.

In addition, the analyst should be informed as to whether the valuation subject is encumbered by a shareholders' agreement, or buy/sell agreement, or any other contractual provisions that would restrict transferability or would otherwise affect the security value.

Of course, the analyst has to be instructed as to the appropriate valuation date (typically the date of ownership transfer, for transfer tax purposes). The analyst has to be instructed as to the appropriate standard (or definition) of value. For transfer tax purposes, the appropriate standard of value is typically fair market value.

The analyst has to be informed as to the appropriate premise of value. For transfer tax purposes, the typical premise of value regarding a private business ownership interest is value in continued use—or value on a going-concern basis.

However, the analyst should also consider the highest and best use ("HABU") of the private company operating assets. It is at least possible that the HABU of the subject private company would be reflected by the valuation premise of value in exchange—as an orderly disposition of the company's assets.

Levels of Value

Finally, the analyst should consider the appropriate level of value. The concept of level of value is sometimes overlooked by the taxpayer or the tax planner—or even the tax counsel. However, the concept of level of value is not overlooked by the Service or other taxing authorities, and it should not be overlooked by the analyst.

In the transfer tax valuation of a business, business ownership interest, or security, the level of value encompasses two primary considerations:

1. The marketability of the subject ownership interest
2. The ownership control attributes of the subject ownership interest

As a simplified introduction, the marketability consideration involves how easy it is for the owner to sell the subject interest ownership and convert it into immediate cash proceeds. The ownership control consideration involves how much influence the subject ownership interest has over the operations of the subject private company.

As will be discussed below, the ownership attributes of marketability and control are not absolute considerations. Rather, they are each represented by a continuum. That is, ownership interests are typically not perfectly marketable nor are they perfectly nonmarketable. Rather, they typically exist somewhere along a continuum of marketability.

Likewise, ownership interests typically do not represent absolute control or absolute noncontrol of the private company. Rather, ownership interests typically exist somewhere along a continuum of control rights and privileges.

The issue of level of control directly affects the transfer tax valuation when the analyst has to adjust a value indication concluded on one (i.e., the unintended) level of value in order to conclude another (i.e., the intended) level of value.

For example, the valuation analyst may conclude the value of a private company ownership interest on a marketable basis—but the appropriate level of value is a nonmarketable basis. In such an instance, the analyst has to account for that difference in ownership attributes—and in value.

Likewise, the valuation analyst may conclude the value of a private company ownership interest on a controlling basis—but the appropriate level of value is a noncontrolling basis. In such an instance, the analyst has to account for that difference in ownership attributes—and in value.

To account for these differences in ownership attributes, the analyst will apply "valuation adjustments." These valuation adjustments can involve the application of either valuation premiums (i.e., incremental value adjustments) or valuation discounts (i.e., decremental value adjustments). The reason for the analyst applying a valuation adjustment is to get from "what you have" to "what you want."

In the above paragraph, "what you have" is a value indication that was developed to indicate a level of value different from the level of value that is appropriate to the transfer tax valuation assignment. "What you want" is the level of value that corresponds to the actual subject ownership interest in the transfer tax valuation assignment.

As discussed below, the requirement for such a valuation adjustment is created by the fact that some generally accepted business valuation approaches and methods typically conclude one level of value. That concluded level of value may not be the level of value that is appropriate for the transfer tax valuation assignment.

For example, the application of the market approach guideline publicly traded company ("GPTC") method typically concludes a marketable ownership interest level of value. However, if the valuation subject is actually a nonmarketable business interest, then the analyst may apply a discount for lack of marketability ("DLOM").

This DLOM valuation adjustment "adjusts" the GPTC method value indication to make it more applicable to, say, the nonmarketable stock of a private company. That is, the analyst applied the valuation adjustment in order to get from "what you have" (i.e., a marketable security value indication) to "what you want" (i.e., a nonmarketable security value indication).

Some generally accepted business valuation approaches and methods typically conclude a controlling ownership interest level of value. For example, the application of the market approach guideline merged and acquired company ("GMAC") method typically concludes a controlling ownership interest level of value. However, if the subject of the transfer tax valuation is a noncontrolling ownership interest, then the analyst may have to apply a discount for lack of control ("DLOC") valuation adjustment in order to conclude a meaningful value conclusion.

The analyst's consideration related to the application of a DLOC in a transfer tax valuation is the subject of this discussion.

The difference in the price that a willing buyer would pay for a controlling ownership interest compared to an otherwise comparable noncontrolling ownership interest may represent a material value adjustment. This price difference is often referred to as the DLOC.

The DLOC measures the difference between:

1. the price that a willing buyer would pay for a private company controlling business ownership interest and
2. the price that a willing buyer would pay for an otherwise identical private company noncontrolling business ownership interest.

This discussion summarizes (1) the concept of ownership control in a transfer tax valuation, (2) the reasons why analysts apply a valuation adjustment (i.e., a price discount or a price premium) in a private company business valuation, (3) the theoretical models and the empirical studies that analysts typically consider in order to measure the amount of any DLOC, and (4) the factors that may influence the magnitude of the DLOC in any particular transfer tax valuation.

The Concept of Ownership Control

By definition, the owner of a noncontrolling ownership interest in a private company:

1. lacks many of the so-called perquisites of ownership and
2. has little or no control over the private company's operating, investing, and financing activities.

A willing buyer contemplating the purchase of a noncontrolling business ownership interest from a willing seller would consider the economic disadvantages associated with that lack of ownership control. As a result, a noncontrolling business ownership interest in a private company is often worth less, on a pro rata or per-ownership-interest basis, than a controlling business ownership interest in the same private company.

The value of ownership control derives from the business owner's ability to influence the private company by exercising what are often called the prerogatives of control.

The following nonexhaustive list indicates some of the typical prerogatives of ownership control with regard to the operation of a private company:

1. Ability to select the management of the company
2. Ability to determine management compensation (including bonuses) and other employment perquisites
3. Ability to set operational and strategic policy and change the course of the company's business operations
4. Ability to acquire and/or liquidate some—or all—of the company's assets
5. Ability to select suppliers, vendors, and subcontractors with whom the company will do business (including self-selection)
6. Ability to borrow funds, repay long-term debt, or otherwise enter into financing transactions on the behalf of the entity
7. Ability to liquidate, dissolve, sell, or recapitalize the company—or to enter into a merger transaction
8. Ability to declare and pay dividends or other distributions—or to decide not to pay such distributions
9. Ability to change the company's articles of incorporation, partnership or limited liability company agreement, or bylaws
10. Ability to enter into leases, licenses, or other contracts (including entering into self-dealing contracts)

However, these so-called prerogatives of ownership control, which are typically associated with a private company controlling ownership interest, possess little value in and of themselves. Instead, the value of owning a controlling ownership interest in a private company is derived from the controlling owner's ability to exercise those prerogatives of ownership control so as to generate economic benefits that would be greater than the economic benefits generated under the company's current stewardship.[1]

Therefore, a rational investor would not be willing to pay a price premium for a controlling ownership interest unless the change of control transaction would allow that investor to exercise some—or all—of the prerogatives of ownership control in order to achieve incremental economic benefits.[2]

In general, such economic benefits can be accomplished by (1) increasing the available cash flow—either the company's total cash flow generation or the amount of cash flow available to the controlling owner and/or (2) decreasing the investor's required rate of return on investment in the subject company (i.e., by decreasing the risk of the business interest investment to the controlling owner).

If the subject private company is already being managed with a high degree of effectiveness and efficiency, then, potentially, the investor may not be able to increase the company's total cash flow generation. In such an instance, there may be relatively little incremental value that would result from a change-in-control transaction.

In such a case, most—or all—of the incremental value associated with the ownership control position would result from the investor (i.e., the controlling owner) redirecting economic benefits away from the noncontrolling owners (or from other company stakeholders)—and to the controlling owner.

It is up to the analyst to consider whether or not a change of control transaction could result in (1) increased cash flow (either to the private company overall—or redirected cash flow to the control owner) and/or (2) decreased required rate of return on investment for the subject ownership interest (either decreased risk due to the private company overall—or decreased risk solely due to the control owner).

And, if the analyst considers that a change of control transaction could result in increased economic benefits (either to the private company overall—or solely to the controlling owner), then it is up to the analyst to identify the specific factors that would support that conclusion.

Another factor that the analyst would consider when deciding whether or not to apply a DLOC in the analysis is the business valuation approach and method that was applied to reach the value conclusion. In other words, the analyst should consider what level of value was concluded from each valuation method's value indication before considering the application of a DLOC.

For example, as discussed below, the application of the income approach discounted cash flow ("DCF") method may conclude a value indication that represents either a noncontrolling ownership interest level of value or a controlling ownership interest level of value. The DCF method level of value indication depends on the components of the financial projections and on the components of the present value discount rate that are applied in that valuation method.

In instances in which the valuation method is applied to already conclude a noncontrolling ownership interest level of value, it may be unnecessary for the analyst to apply a DLOC. This is because the DCF method resulting value indication is already concluded from the perspective of a noncontrolling investor.

Alternatively, the application of the market approach GMAC method (often also called the guideline transaction method) typically concludes a value indication on a controlling ownership interest level of value basis. In that instance, it may be appropriate for the analyst to apply a DLOC to the value indication derived by the GMAC method. The application of the DLOC would then adjust the GMAC method value indication so as to conclude a noncontrolling ownership interest level of value.

The analyst's decision to apply a DLOC in the transfer tax valuation of a private operating company is typically a three-step process.

The first step in this process is for the analyst to determine whether the valuation method applied in the analysis develops a value indication that concludes (1) a controlling ownership interest level of value or (2) a noncontrolling ownership interest level of value.

Depending both (1) on the level of value of the valuation subject ownership interest and (2) on the purpose and objective of the business valuation, further adjustments and analysis may not be needed after making that determination.

That is, the analyst has to conclude whether the selected valuation method already develops a value indication on a noncontrolling ownership interest basis. If so, it may not be necessary for the analyst to adjust the value indication by applying a DLOC.

The second step in the process is for the analyst to determine whether a change in control transaction could result in incremental economic benefits to a controlling owner. If so, that analyst determination may indicate that there is a material difference between:

1. the fair market value of a noncontrolling ownership interest and

2. the fair market value of a controlling ownership interest.

The third step in the process is for the analyst to determine the magnitude of any incremental economic benefits available to the control owner—in order to estimate the amount of any applicable DLOC.

Reasons to Apply a Valuation Adjustment

All other valuation variables assumed to be equal, the investment risk of a noncontrolling ownership interest is typically greater than the investment risk of a controlling ownership interest in the same private company.

The greater investment risk stems from (1) the noncontrolling interest holder's inability to exercise the prerogatives of ownership control and (2) the potential for the controlling interest holder to make decisions (and to implement procedures) that are detrimental to the noncontrolling ownership interest holder.

Accordingly, the difference in value between a noncontrolling ownership interest and a controlling ownership interest may be representative of this difference in investment risk.

As described above, the magnitude of the difference in investment risk—and its overall impact on the subject interest's fair market value—can vary greatly depending on the specific factors related to:

1. the subject ownership interest and
2. the subject private company.

Theoretical Methods to Quantify the DLOC

Application of the Discounted Cash Flow Model

The DCF business valuation method is based on the principle that the value of a private company—or an ownership interest/security in such a company—equals the present value of future income expected to be generated by that company or ownership interest. Consequently, all other valuation variables assumed to be equal, if future company/security income increases, then the fair market value of the company/security increases.

As discussed earlier, a controlling ownership interest may be valued at a price premium to an identical noncontrolling ownership interest if the controlling interest holder is able to enhance his or her economic benefits by exercising all—or some—of the prerogatives of ownership control.

This increase in economic benefits to the control owner can be accomplished by:

1. increasing the company's total cash flow or the control owner's specific cash flow and/or
2. decreasing the company's—or the control owner's—required rate of return on investment.

With respect to a DLOC, the analyst may apply a functional analysis to determine whether a change of control transaction could (1) enhance the company's or the control owner's cash flow or (2) decrease the company's or the control owner's required rate of return on investment.

To make this determination, the analyst may (1) develop a DCF valuation analysis by applying financial projections from a noncontrolling ownership interest perspective, (2) develop a DCF valuation analysis by applying financial projections from a controlling ownership interest perspective, and (3) compare the two value indications provided by the two DCF valuation analyses.

This comparison should help the analyst to determine the value adjustment (i.e., price discount) attributable to a lack of ownership control (or, alternatively, the price premium attributed to ownership control).

It is noteworthy that, if the analyst is able to estimate a value conclusion for both (1) a noncontrolling level of value DCF valuation analysis and (2) a controlling level of value DCF valuation analysis, then the resulting value conclusions likely do not need to be further adjusted for ownership control attributes.

That is, if the transfer tax valuation objective is to estimate the fair market value on a noncontrolling ownership interest basis, and if the DCF valuation analysis develops a noncontrolling ownership interest level of value, then it is not necessary to apply an additional DLOC to that value indication.

However, the analyst may compare the two value indications developed by the two DCF valuation analyses in order to estimate an applicable DLOC percentage to apply to controlling ownership interest value indications developed by the other generally accepted business valuation approaches and methods.

Factors to Consider in the Application of the Discounted Cash Flow Model

As previously discussed, the analyst may perform some type of functional analysis to determine the extent to which a change of control transaction may result in an opportunity to enhance the control owner's economic benefits.

The following list provides some of the ways that the cash flow (i.e., either the total company's cash flow or the control owner's cash flow) may be increased through a change of control transaction:

1. Increased revenue growth
2. Increased operating profit margins
3. Working capital efficiencies
4. Capital expenditure efficiencies

It is noteworthy that many of the above-listed economic benefits may not be achievable simply through a change of control transaction. Often, the achievement of these economic benefits is contingent on the new controlling owner:

1. having access to alternative markets,
2. commercializing alternative production and supply channels, or
3. exploiting post-control event synergies or economies of scale.

In those instances, it may be important for the analyst to distinguish between:

1. the economic benefits that would be attributable to synergies that a specific new control owner may be able to achieve and
2. the economic benefits that any typical (or hypothetical) new controlling owner may be able to achieve.

It is possible that a change of control transaction may not either increase the private company revenue or decrease the private company operating expenses or capital costs. If the subject private company is already operated efficiently, there may be few opportunities to generate incremental cash flow. This means that the ownership control price premium or, conversely, the DLOC may be relatively small—at least at the total company level.

Nonetheless, the new control owner may still be willing to pay a control price premium. This control price premium would result from the control owner being able to divert economic benefits away from the noncontrolling owners—or from other company stakeholders.

The value of a controlling ownership interest may also be increased due to a decreased required rate of return on investment resulting from a change of control transaction. Such a decrease in the required return on investment would be associated with a decrease in the investment risk to the new control owner.

The following list provides some of the ways that a decrease in the required rate of return on investment may be achieved through a change of control transaction:

1. Optimized company capital structure
2. Greater access of the company to capital
3. Diversification of the company's operating risk

As is the case for a post-transaction increased net cash flow, the ability to influence the required rate of return on investment may be unobtainable simply through a change of control transaction. For example, if the private company's capital structure is already at an optimal level, then there may be little opportunity to decrease the required rate of return on investment by altering the company's capital structure.

Again, the control owner could still reduce his or her investment risk—and reduce his or her required return on investment—by diverting risk to the noncontrolling owners—or to other company stakeholders.

The analyst may perform a functional analysis to determine whether a change of control transaction could result in increased net cash flow (to the company or to the control owner) or decreased investment risk (to the company or to the control owner).

The analyst should consider the possibility of achieving the results listed above, as well as other company-specific factors discussed below, when considering the application of a DLOC.

Company-Specific Factors

The analyst should also consider company-specific factors when evaluating the prospect of enhancing economic benefits under a change of control transaction.

Analysts often consider the following nonexhaustive list of company-specific factors when considering whether or not the application of a DLOC is appropriate to the transfer tax valuation:

1. The current stage of the private company's life cycle

2. The quality of the private company management
3. The level of the company management compensation
4. The company's capital structure
5. The current management's goals and objectives
6. The regulatory risk factors in the private company's industry
7. Guidance provided by the company's corporate governing documents

After considering the aforementioned factors and how they apply to the circumstances surrounding the subject ownership interest, the analyst may determine whether the application of a DLOC is appropriate to the transfer tax valuation.

Empirical Studies to Quantify the DLOC

The analyst may determine that a DLOC is applicable based on:

1. the business valuation approaches and methods applied and
2. the company-specific factors described above.

Based on that judgmental determination, the analyst may rely on empirical studies to help quantify the amount of the DLOC.

Generally, empirical studies apply analyses that are based on empirical capital market transaction observations—rather than on theoretical economic principles. Empirical studies typically rely on actual transactional data to provide evidence for estimating a DLOC.

There are two types of empirical data that analysts may consider to help quantify the DLOC for a noncontrolling ownership interest in a private company:

1. Studies of the stock price premiums offered (over the pre-tender-offer market price) in the acquisition of publicly traded companies (i.e., going-private acquisition price premium data)
2. Analyses of share price variations from the net asset value of publicly traded closed-end mutual funds (i.e., closed-end mutual fund pricing data)

Public Company Acquisition Price Premium Data

One source of data that analysts sometimes consider in measuring a DLOC is the study of public company "going-private" acquisition tender offers. By considering public company stock acquisition price premiums offered during a change of control transaction, the analyst may obtain some empirical guidance as to the pro rata value difference between a controlling ownership interest and a noncontrolling ownership interest.

Acquisition tender offer price premiums vary widely, with the median tender offer tender offer price premium typically ranging from approximately 25 percent to approximately 40 percent over the average public market price in the months just prior to the offer announcement. The high end of the range of public company stock tender offers includes acquisition price premium of over 100 percent and the low end of the range includes acquisition price discounts.

Both ends of the range indicate that there may be special factors involved. It is noteworthy that an acquisition price premium of 25 percent to 40 percent is equivalent to a pre-acquisition price discount of approximately 20 percent to 29 percent.[3]

That is, the acquisition price premiums reported in the acquisition tender offer empirical studies often include consideration paid for the acquirer for expected synergistic value. All things considered, the presence of expected synergistic value would result in relatively larger acquisition price premiums.

Accordingly, acquisition price premium data are often considered to represent the high end or the maximum amount of a reasonable control price premium—or the corresponding DLOC. Alternatively, the analyst may attempt to disaggregate the total acquisition price premium into its two components:

1. Ownership control price premiums
2. Synergistic price premiums

The analyst may apply judgement in order to remove the impact of consideration for synergistic price premiums from the indicated total acquisition price premiums.

In order to do so, the analyst often attempts to distinguish—or allocate—between (1) the portion of the total acquisition price premium that relates to a control price premium only and (2) the portion of the total acquisition price premium that relates to a synergistic price premium.

Some procedures that the analyst may consider in order to make such adjustments to the tender offer acquisition price premium data include:

1. focusing on acquisitive transactions that include financial buyers only, so as to limit the amount of any synergistic price premiums that would presumably be paid in such transactions and
2. focusing on the lower end of the range of indicated acquisition price premium data (e.g., the first quartile of the acquisition price premium data in the measurement of the acquisition price premium).

As a generalized rule of thumb, analysts sometimes look at acquisition price premium data and assign half of the total acquisition price premium to the control price premium and the other half of the total price premium to the synergistic price premium. Analysts sometimes apply this total acquisition price premium allocation procedure as a default procedure. That is, the analyst may apply this simplistic 50 percent/50 percent allocation assumption if there is no other factual basis for performing the total price premium allocation.

Ideally, the analyst would be able to rely on industry-specific or target-company-specific data in order to perform a more supportable total acquisition price premium allocation.

To illustrate the application of this default rule of thumb allocation procedure, let's consider the following simplified example. Let's assume the analyst has selected the appropriate public company acquisition price premium data.

These data would relate to the going-private acquisitions of publicly traded companies in an appropriate Standard Industrial Classification ("SIC") code or industry group. These data would relate to the acquisition of public companies of a size that would provide meaningful pricing guidance to the analyst. And, these public company going-private acquisitions were completed during a time period that would be relevant to the subject valuation date.

Let's assume the analyst considered these acquisition price premium data and concluded that a representative total price premium for the acquired public companies was 40 percent. The analyst understands that only some of that 40 percent total price premium (i.e., the acquisition price paid in excess of the pre-tender-offer publicly traded stock price for the target companies) relates to the transfer of ownership control.

The other reason why the acquirer paid a purchase price premium is the acquirer's expectation of post-merger synergies (unrelated to the transfer of ownership control).

In the absence of any additional industry-specific or acquisition-specific information, the analyst may allocate half of the representative 40 percent total price premium—or 20 percent—to the transfer of ownership control. In other words, the analyst assumed that the control price premium component of the total price premium was 20 percent.

This assumed control price premium still has to be converted into a DLOC. As mentioned above, the DLOC is calculated as the mathematical reciprocal of the control price premium. That is, the DLOC = 1 – [1 ÷ (1 + control premium %)].

In this simplified example, the analyst's assumed 20 percent control price premium would indicate a DLOC of approximately 17 percent. And, again, the 20 percent control price premium is based on the analyst's simplified assumption regarding the allocation of the total acquisition price premium indication.

Closed-End Mutual Fund Pricing Data

Analysts also extract noncontrolling ownership interest DLOC measurement guidance from the analysis of publicly traded closed-end mutual fund pricing data. By observing the difference between the closed-end mutual fund share price and the closed-end mutual fund per-share net asset value, a price discount/price premium to net asset value may be calculated.

In a publicly traded closed-end mutual fund, a shareholder is unable to exercise control over the fund's investment portfolio. Similarly, in a private company, typically a noncontrolling shareholder is unable to exercise the prerogatives of ownership control to influence the operation of the private company.

Analysts often consider the research regarding the reasons why many closed-end mutual funds typically trade at a price discount to net asset value.

Some of the following reasons have been suggested by that research:

1. Poor operating performance of the mutual fund
2. Weak management of the mutual fund
3. Poor prospects for the mutual fund
4. High expense ratios within the mutual fund
5. Low cost basis assets within the fund
6. Lack of diversification of the fund's investment portfolio

As intuitive as some of the above-listed factors may appear, there remains little empirical evidence that conclusively explains why closed-end mutual funds typically trade at a stock market price discount compared to their per-share net asset value.

It is noteworthy that ownership interests in publicly traded closed-end funds are similar to a noncontrolling ownership interest in a private company in many respects. A noncontrolling private company owner is:

1. in no position to influence the private company management and
2. dependent on the decisions made by the controlling owner.

Likewise, for a noncontrolling owner of a closed-end fund, a closed-end fund shareholder is:

1. not in a position to influence the management of the mutual fund portfolio and
2. dependent on decisions made by the mutual fund manager.

This lack of control over the assets of the private company or the mutual fund provides a reasonable explanation why a DLOC may be applicable to the valuation (1) of the private company business interest or (2) of the closed-end mutual fund shares.

It is generally accepted that the observed closed-end fund price discount data provides guidance with respect to a DLOC (and not to a discount for lack of marketability). That is, shares of publicly traded closed-end funds trade on an organized stock market exchange. Therefore, shares of the publicly traded closed-end funds are as liquid as most fully marketable equity securities.

Valuation Example

A simplified example may illustrate the impact of the DLOC on the transfer tax valuation. Let's assume that Thomas D. Taxpayer owned 25 percent of the limited liability company ("LLC") membership units of Private Construction Company, LLC ("Private LLC").

Let's assume that Tom Taxpayer passed away on September 30, 2020. Accordingly, his private company business ownership interest is included in his estate.

Let's assume that tax counsel for the estate retains the analyst to estimate the fair market value of Tom's ownership interest for estate tax return preparation purposes. The analyst starts the transfer tax valuation assignment by valuing all of the Private LLC owner's equity.

The analyst applied the generally accepted business valuation approaches and methods.

The analyst developed an income approach and DCF method value indication (by considering the total cash flow expected to be generated by the construction company operations).

The analyst developed a market approach and GMAC method value indication (by analyzing recent sale transactions of comparable construction companies).

And, the analyst developed an asset-based approach and asset accumulation method value indication (by estimating the current market value of all of the company's tangible assets and intangible assets).

Based on a synthesis of the value indications provided by these three generally accepted business valuation approaches, the analyst concluded that the fair market value of 100 percent of the Private LLC owners' equity was $100 million, as of September 30, 2020.

Tom passed away owning 25 percent of the company's LLC units. Therefore, the fair market value of the ownership interest in Tom's estate appears to be $25 million.

The $100 million fair market value conclusion may be appropriate for the Private LLC entire business. But, let's say there were four equal partners (technically, members) who owned Private LLC. If all four members (including the executor of Tom's estate) decided to sell Private, LLC, they would expect to receive $100 million in total sale price consideration for the entire company.

However, this transaction represents the transfer of a marketable, controlling ownership interest in the company. Collectively, all four members can decide to sell Private LLC—and thereby make it marketable. Collectively, all four members would transfer control of the total company to the new owner (say, a corporate acquirer).

Therefore, the $100 million transaction price represents the value of a marketable, controlling ownership interest in Private, LLC.

However, Tom's estate does not own a marketable, controlling ownership interest. Rather, Tom's estate owns a nonmarketable, noncontrolling ownership interest in Private, LLC. Unlike the market for the entire construction company, there is no market for Tom's block of LLC units in Private LLC.

In fact, those units may be subject to the contractual transferability restrictions included in the company's membership agreement. In addition, Tom's block of LLC units would provide the new owner with little or no control over the operations of Private, LLC.

At this stage in the transfer tax valuation, the analyst will apply a DLOM and a DLOC to the pro rata Private, LLC, business value in order to conclude the fair market value of the estate's ownership interest. Let's assume the analyst selects a 30 percent DLOM. (A description of DLOM measurement procedures is beyond the scope of this discussion.)

Then, the analyst considered control price premium indications extracted from sale price data related to public construction company going-private acquisitions. In addition, the analyst considered pricing data related to publicly traded mutual fund stock price to net asset value discounts.

Finally, the analyst considered the actual management structures, the corporate governance practices, and the equity ownership allocation of Private, LLC.

Based on all of the above-listed factors, let's assume that the analyst selected a 20 percent DLOC as appropriate to the estate's ownership interest in the Private, LLC, units.

Based on the above set of hypothetical facts and circumstances, the analyst would conclude the fair market value of the estate's ownership interest as presented in Exhibit 1.

In other words, the Tom Taxpayer estate would not report the $25 million ownership interest value for transfer tax purposes. Rather, based on the analyst's fair market value valuation of the subject LLC units (including consideration of the appropriate DLOC), the Tom Taxpayer estate would report the $14 million ownership interest value for transfer tax purposes.

Summary and Conclusion

Valuation analysts are often called on to estimate the fair market value of business ownership interests for transfer tax purposes. These business ownership interests may include private companies,

Exhibit 1
Estate of Thomas D. Taxpayer
Ownership Interest in Private Construction Company, LLC
Fair Market Value
As of September 30, 2020

Transfer Tax Valuation Analysis	(in millions)
Fair Market Value of the Private, LLC, Total Equity	$100.0
Multiplied by: Tom Taxpayer Estate LLC Units Percentage Ownership	25%
Fair Market Value Indication of the Estate Ownership Interest—on a Marketable, Controlling Ownership Interest Basis	$25.0
Less: 30% Discount for Lack of Marketability	7.5
Equals: Subtotal	$17.5
Less: 20% Discount for Lack of Control	3.5
Equals: Fair Market Value of the Tom Taxpayer Estate LLC Units—on a Nonmarketable, Noncontrolling Ownership Interest Basis	$14.0

ownership interests in such companies, and the debt and equity securities of such companies.

The transfer tax at issue may be a gift tax, estate tax, or generation-skipping transfer tax. And, such valuations may be performed for tax planning, compliance, audit support, or litigation purposes.

One of the factors that the analyst considers in the transfer tax valuation of the private company business interest is the level of value. The business ownership interest's level of value is primarily described by two elements:

1. Marketability
2. Control

That is, the analyst will assess where the subject business interest falls in the continuum ranging from (1) perfectly marketability to (2) perfectly nonmarketable.

In addition, the analyst will assess where the subject business interest falls in the continuum ranging from (1) total ownership control to (2) a total lack of ownership control.

Some of the generally accepted business valuation approaches and methods typically conclude a value indication on a controlling ownership interest level of value. When the analyst applies such a business valuation method, a controlling ownership interest level of value indication is "what you have." If the subject of the transfer tax valuation is a noncontrolling business ownership interest, a noncontrolling ownership interest level of value indication is "what you want."

In order to get from "what you have" (a controlling interest level of value indication) to "what you want" (a noncontrolling interest level of value conclusion), the analyst typically has to quantify—and apply—a DLOC.

This discussion summarized the factors that the analyst typically considers in the application of a DLOC in a transfer tax valuation.

In estimating the DLOC, an analyst should consider all of the facts and circumstances relevant to the subject business ownership interest. Based on the facts of the specific valuation analysis, there are times when certain factors are more relevant than others.

Based on consideration of the factors mentioned above, the analyst may determine that a change of control transaction may result in:

1. increased cash flow to the private company or to the control owner and/or
2. a decreased required rate of return on investment for the private company or to the control owner.

In such an instance, there may be a difference between:

1. the value of a noncontrolling ownership interest in the private company and
2. the value of a comparable controlling ownership interest in the private company.

However, the application of a DLOC is only appropriate if the business valuation method applied by the analyst developed a value indication on a controlling ownership interest level of value basis. If the business valuation method applied by the analyst already developed a value indication on a noncontrolling ownership interest level of value basis, then it would be unnecessary to quantify and apply a DLOC.

If the analyst concluded that there is little or no incremental value that can be derived from a change of control transaction—particularly to the control owner—that conclusion may indicate that there is little difference between:

1. the controlling ownership interest level of value for the subject business interest and
2. the noncontrolling ownership interest level of value for the subject business interest.

In such an instance, it may be appropriate for the analyst to apply a minimal (or no) DLOC in the transfer tax valuation of the subject business ownership interest.

Notes:

1. VFR Valuation Advisory #3: The Measurement and Application of Market Participant Acquisition Premiums, 9.
2. Ibid.
3. Price discount calculated as 1 – [1/(1 + price premium)]

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