



COMMITTEE REPORT: VALUATIONS

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Charitable Contributions of Complex Assets

Consider value adjustments based on marketability limitations

In performing a valuation of complex assets for charitable contributions purposes, it may be appropriate to apply value adjustments based on an assessment of the marketability limitations of the subject assets. Valuation analysts should exercise special care to maintain consistency when valuing charitable contribution assets in light of prior valuations of similar assets that were prepared for taxable transfers to non-tax-exempt entities.

Valuation Basics

Historically, the majority of valuations attached to U.S. federal gift tax returns were prepared in the context of donors gifting to non-tax-exempt recipients, such as family members. With the rise of donations of complex assets, such as closely held company stock, restricted stock, limited partnership interests and limited liability company interests, valuation analysts are more frequently asked to value such assets for charitable contribution purposes. To the extent that the value of the contributed asset meets certain dollar thresholds, the valuation is required to be attached to the donor's U.S. federal income tax returns.

In general, the recipient's tax-paying status determines how a gift will affect the donor's tax liability. A donor making a gift to a non-tax-exempt entity, such as a family member, may incur a gift tax liability if the transfer was structured as a taxable gift. In these situations, a relatively low value placed on the transferred asset

would translate to a relatively low gift tax on the transfer. In contrast, a donor making a gift to a tax-exempt entity will typically be able to maximize his income tax deduction—and, as a result, reduce his income tax liability—if the value of the gift is relatively high. The value of the gift to a tax-exempt entity may be treated as a tax deduction on the donor's U.S. federal income tax return. The analyst should carefully perform a tax-related analysis—whether for gift tax purposes or income tax purposes—because of the opposing inherent biases that the donor may have with respect to the analysis.

A common dispute between the Internal Revenue Service and the taxpayer/donor over the valuation of gifts of complex assets centers on the size of the discount for lack of marketability (DLOM) applied to the valuation. Estimating an appropriate DLOM requires consideration of several important features of the subject asset. The analyst should maintain consistency in evaluating these features from case to case. In other words, if the analyst has estimated a relatively high DLOM in the valuations of gifts to non-tax-exempt entities, then taking a different position (that is, a relatively low DLOM) in the valuation of a similar ownership interest that's transferred to a tax-exempt entity will likely be subject to scrutiny. While there are other adjustments that may be appropriate in the valuation of a complex asset for charitable contribution purposes, we'll focus on the DLOM and how the specific features of the complex asset influence its valuation.

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IRC Guidance

Valuations of charitable contributions should be prepared in accordance with the applicable provisions of Internal Revenue Code Section 170. Important guidance prescribed in the IRC includes: (1) the standard of value, (2) the definition of a charitable contribution, (3) what types of charitable contributions require an



independent qualified appraisal, and (4) the definitions of a “qualified appraisal” and “qualified appraiser.”

Standard of value. The standard of value for all non-cash charitable contributions claimed as deductions on a donor’s U.S. federal income tax return is fair market value (FMV). FMV is defined as, “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.”¹ Various courts have additionally stated that the hypothetical buyer and seller are assumed to be willing and able to trade and well informed about the property and the market for such property.

Charitable contribution. The IRC definition of a charitable contribution includes a contribution or gift to or for the use of a corporation, trust or community chest, fund or foundation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involves the provision of athletic facilities or equipment) or for the prevention of cruelty to children or animals.²

Charitable contributions requiring appraisals. For charitable contributions that exceed certain dollar thresholds, the IRS requires qualified appraisals to be performed in support of the amount of the tax deduction on the donor’s return. In the case of contributions of property for which a deduction of more than \$5,000 is claimed, disclosure requirements are met if the individual, partnership or corporation obtains a qualified appraisal of such property. The taxpayer should attach the qualified appraisal, and such other information as the Secretary of the Treasury (the Secretary) may require, to the return for the taxable year in which such contribution is made. If contributions of property for which a deduction of more than \$500,000 is claimed, disclosure requirements are met if the individual, partnership or corporation attaches to the return for the taxable year in which such contribution is made a qualified appraisal of such property.³ (For more information on qualified appraisals, see “The Qualified Appraisal Rules,” by Jonathan G. Tidd, in this issue, p. 14.)

Qualified appraisal and qualified appraiser. The IRC broadly defines a “qualified appraisal” as an appraisal that: (1) conforms to the regulations or other guidance prescribed by the Secretary, and (2) is conducted by a qualified appraiser in accordance with generally accepted appraisal standards.⁴

An appraisal is considered to be conducted according to generally accepted appraisal standards if, for example, it’s consistent with the substance and principles of the Uniform Standards of Professional

The most common type of asset contributed to charities has been, and will likely continue to be, cash or some form of cash equivalent.

Appraisal Practice, as developed by the Appraisal Standards Board of The Appraisal Foundation.

A qualified appraiser, according to the IRC, is an individual who: (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary, (2) regularly performs appraisals for which the individual receives compensation, (3) meets such other requirements as may be prescribed by the Secretary in regulations or other guidance, (4) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and (5) hasn’t been prohibited from practicing before the IRS by the Secretary under Section 330(c) of Title 31, United States Code, at any time during the 3-year period ending on the date of the appraisal.⁵

Charitable Giving Asset Types

The most common type of asset contributed to charities has been, and will likely continue to be, cash or some form of cash equivalent. However, as the level of



wealth increases among donors, and as more donors retain charitable planning advisors, the types of assets directed to charitable organizations is expected to broaden. These asset types generally fall under the following primary categories: (1) marketable, publicly traded securities, (2) non-cash assets, such as equipment, furniture, art and collectibles, and (3) complex assets, which generally include non-marketable business ownership and investment interests.

Complex assets provide a strategic way to maximize giving in a tax-advantaged manner. Therefore, charitable planning advisors often recommend

As complex assets become a more common type of charitable contribution, there will be greater visibility and scrutiny placed on the asset valuations that are attached to the donor's U.S. federal income tax return.

including such assets in a high-net-worth (HNW) donor's charitable contribution strategy:

With such a high percentage of Americans'—and especially baby boomers'—wealth tied up in privately held business interests, the opportunity is huge for both clients and advisors as this group seeks help in monetizing these assets for key life goals.⁶

As complex assets become a more common type of charitable contribution, there will be greater visibility and scrutiny placed on the asset valuations that are attached to the donor's U.S. federal income tax return. For the most part, the greatest scrutiny of the valuation isn't focused on the fundamental valuation of the

complex asset, but rather on certain adjustments applied to the asset's preliminary value in the form of a DLOM.

Therefore, it's important that the analyst understand the features of the contributed complex asset and appropriately estimate a DLOM that's objective and defensible.

Complex Asset Features

When donors make contributions of complex assets, it's necessary to value the contributed property for the purpose of claiming an income tax deduction on the donor's U.S. federal income tax return.

As indicated earlier, the donor's valuation bias may be different when making gifts to tax-exempt entities than when making gifts to non-tax-exempt entities. A donor has an economic incentive to increase the claimed value of a business interest that's contributed to a tax-exempt entity to increase the donor's potential income tax deduction. The increased income tax deduction will result in lower income taxes for the donor.

Regardless of the tax-paying status of the recipient entity, it's often appropriate to apply a DLOM in the valuation of a business interest that's not freely traded in the public marketplace. The consensus among valuation analysts, judicial decisions and empirical studies is that an investment is worth more if it's readily marketable and worth less if it's not. The difference in the price that an investor will pay for a liquid asset compared to an otherwise comparable illiquid asset is often substantial. This difference in price is commonly referred to as the DLOM.

When estimating the DLOM, the analyst estimates how quickly an interest holder would be able to attract buyers, sell the ownership interest and receive a return of capital. This aggregate time period is often called the "period of illiquidity." If the period of illiquidity for the subject private business interest is comparable to the period of illiquidity for a publicly traded, unrestricted security (approximately one to three days), then a DLOM may not be appropriate for the private business interest. However, the longer and less predictable the period of illiquidity becomes, the higher the appropriate DLOM.

Estimating the appropriate DLOM for a private business interest also involves consideration of several asset-specific features that impact an interest holder's



ability to market the asset and to attract suitable buyers. A careful review of an entity’s organizational documents, in addition to discussions with the entity’s management, will generally provide the analyst with an understanding of how each feature influences the selected DLOM.⁷ It’s also important to consider the overlap or interplay between the various asset features.

“Complex Asset Features,” this page, includes seven asset-specific features that are commonly considered when calculating a DLOM for a business interest. The seven selected asset features, grouped by importance in tiers, are discussed below.

Ownership Control

For purposes of this discussion, ownership control is considered to be a Tier I asset feature. There’s an inverse relationship between the magnitude of control that an equity holder has over a business and the DLOM. This means that the greater the level of control an interest holder can exercise over an entity, the lower the DLOM.⁸

Generally, the level of control an interest holder has over an entity is measured by: (1) the equity holder’s ownership percentage of the voting shares/units of the entity, and (2) the powers and authority granted to the holder of the subject voting shares/units by the entity’s organizational documents. These powers and authority may include the ability to make business decisions

that impact, among other things, the interest holder’s investment.

This particular feature could potentially allow the asset holder to change other asset features, such as the ability to withdraw from the entity, cash distributions and the period of illiquidity. Such changes could render the importance of this single asset feature extremely high.

In the context of charitable giving, the donor has an incentive to contribute a business interest that has certain elements of ownership control. By doing so,

The ability of an interest holder to withdraw from an entity may have a significant effect on the liquidity of an ownership interest.

the donor can potentially benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction.

Right of Withdrawal

The right to withdraw from an entity is generally also considered to be a Tier I asset feature. There’s an inverse relationship between the ability to withdraw and the DLOM. The easier it is for an interest holder to withdraw from an entity, the lower the DLOM.

The ability of an interest holder to withdraw from an entity may have a significant effect on the liquidity of an ownership interest. Liquidity generally relates to the ability to sell the investment quickly and easily and to receive cash.

Even in instances in which: (1) the interest holder doesn’t have control over the entity, (2) cash distributions are low, and (3) there are no plans for any type of near-term liquidity event, the ability to withdraw from the entity may provide the interest holder an opportunity to receive cash for the ownership interest in a relatively short period of time. In these instances, similar to those involving liquid, publicly traded securities, applying a DLOM in the subject ownership interest valuation may not be

Complex Asset Features

Consider these factors when calculating a discount for marketability for a business interest

Tier I	Tier II	Tier III
Ownership control	Transferability	Access to entity financial information
Right of withdrawal	Cash distributions	
Put/call option rights	Prospect of a liquidity event	

—Shannon P. Pratt, *Valuing A Business—The Analysis and Appraisal of Closely Held Companies, Fifth Edition, Chapter 17*



appropriate. However, the analyst may also consider that a right to withdraw from an entity doesn't necessarily translate to the ability to receive cash in a few days. In many entities that allow interest holders the right to withdraw, the payment of the withdrawal proceeds isn't made for several months following the notification of withdrawal. In such instances, applying a DLOM, albeit a relatively low one, may be appropriate.

In the context of charitable giving, the donor has an incentive to contribute a business interest that has the right to withdraw from the subject entity. By doing so, the donor can potentially benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction.

Generally, there's an inverse relationship between a business interest having a put option right and the DLOM.

Put/Call Option Rights

Put option and call option rights on business interests are also considered to be Tier I asset features. Generally, there's an inverse relationship between a business interest having a put option right and the DLOM. Specifically, a put option right with a strike price that's at FMV (that is, at-the-money) or favorable to the interest holder (that is, in-the-money) generally decreases the DLOM. Generally, there's a positive or direct relationship between a business interest having a call option right (that is, redemption right) and the DLOM. Specifically, a call option right with a strike price that's favorable to the buyer (usually the subject entity) increases the DLOM.⁹

A put option right allows the holder of the business interest the right, but not the obligation, to sell its interest at the strike price of the option. If the strike price is at or higher than the FMV of the business interest, the interest holder has an economic incentive to exercise the option right and sell its ownership interest (usually

back to the entity, but it can also be to the other equity holders). Similar to the withdrawal feature discussion above, the analyst should consider whether exercising the interest holder's option to sell translates to the ability to receive cash in a few days. If the payment of the put option proceeds isn't made for several months following the date the option is exercised, applying a relatively low DLOM may be appropriate. However, if the put option proceeds are received within a couple of days—the typical timeframe to receive proceeds from the sale of publicly traded securities—then applying a DLOM may not be appropriate.



SPOT LIGHT

Makin' Bacon

"Atelier de Francis Bacon" (45.6 in. by 35 in.) by Horacio de Sosa Cordero, sold for \$170,500 at Fine Art Auctions Miami's recent Important Paintings and Sculptures sale on April 27, 2013. The Argentine-born Cordero is actually a member of an ancient aristocratic family from the Castile region of Spain.



A call option right allows the holder of the option the right, but not the obligation, to buy a business interest at the strike price of the option. If the strike price is at or below FMV,¹⁰ the call option holder (usually the subject entity) has an economic incentive to exercise the option and redeem the subject business interest from its holder.

Call option rights generally have a negative impact on the marketability of a business interest (that is, an increase in the DLOM). The call option right may diminish the attractiveness of the business interest to potential buyers.

In the context of charitable giving, the donor has an incentive to contribute a business interest that has a put option right. By doing so, the donor can potential-

ly benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction.

Transferability

The ability to freely transfer a business interest is generally considered to be a Tier II asset feature. There's an inverse relationship between the transferability of an ownership interest and the DLOM. The fewer the restrictions on transferability (that is, high transferability), the lower the DLOM, all else being equal.

The ability of an interest holder to transfer its ownership interest in an entity has an impact on the interest's marketability. If a privately held entity allows transfers of its ownership interests, it's usually among other existing interest holders, the entity and an identified group of equity holders. These parties may specifically be defined as permitted transferees, while all other non-designated parties may be defined as non-permitted transferees.

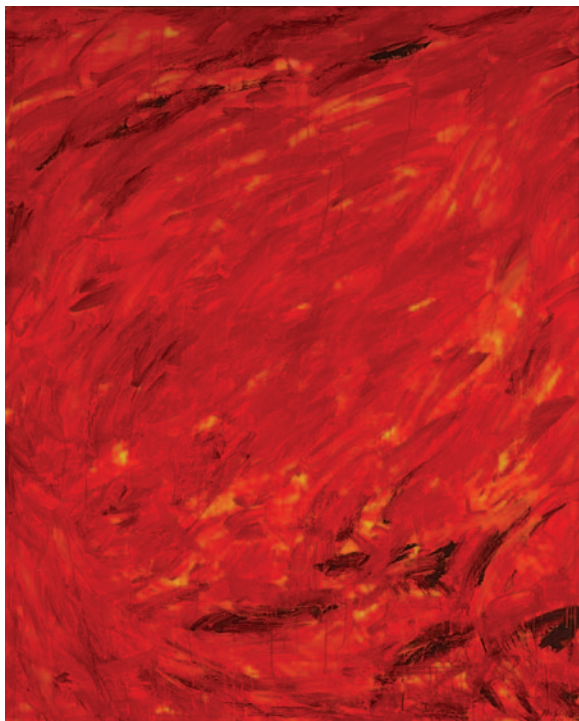
In addition, some entities have a right of first refusal provision, which may have a considerable effect on the marketability of an ownership interest. For example, an interest holder who identifies a buyer willing to purchase its interest may first be required to provide a notice of intent to transfer the ownership interest to: (1) the entity, and (2) the other interest holders. After providing such notice, the entity and/or the other interest holders may have the right to acquire the ownership interest that's the subject of the proposed transfer.

If an entity has a small group of permitted transferees, the DLOM for the entity's ownership interests may be high.¹¹ Additionally, if the entity allows for multiple right of first refusal provisions, and if the length of time to execute each right of first refusal provision is long, then the DLOM for the subject ownership interest may be relatively high.

In the context of charitable giving, the donor has an incentive to contribute a business interest that's not subject to onerous transferability restrictions. By doing so, the donor can potentially benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction.

Cash Distributions

Cash distributions/dividends are an important investment feature for most equity ownership interests. We classify cash distributions as a Tier II asset feature. There's an inverse relationship between the level of cash



SPOT LIGHT

Well Red

"Composition in Red" (63.4 in. by 50.8 in.) by Mubin Orhon, sold for \$212,500 at Fine Art Auctions Miami's recent Important Paintings and Sculptures sale on April 27, 2013. Orhon actually earned degrees in political science and economics before picking up painting after attending a drawing class while in France for his other studies.



distributions paid on a specific ownership interest and the DLOM. **The higher the level of cash distributions, the lower the DLOM.**¹²

The level and frequency of cash distributions an entity provides to its interest holders has an effect on the marketability of the entity's ownership interests. Cash distributions generally enhance the attractiveness of the ownership interest to potential buyers.

In instances in which cash distributions represent a favorable market return on investment, even if many of the other investment features aren't attractive, a relatively low DLOM may be appropriate, as there may be an increase in demand for such investments by potential buyers.

In the context of charitable giving, the donor has an incentive to contribute an ownership interest from an

entity that pays periodic cash distributions to its equity holders. By doing so, the donor can potentially benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction.

Prospect of a Liquidity Event

We classified the probability of a near-term liquidity event as a Tier II asset feature. There are two aspects to a liquidity event feature: (1) the likelihood of a liquidity event, and (2) the expected length of time to gain liquidity. There's an inverse relationship between the likelihood of a liquidity event and the DLOM. The higher the likelihood of a liquidity event, the lower the DLOM.¹³ Conversely, there's a positive or direct relation-

Valuation analysts often find that information access is an important investment feature that influences the pool of potential buyers for an ownership interest.



SPOT LIGHT

Bullseye

"Levant 5" (11.3 in. by 10.6 in.) by Carmelo Arden Quin sold for \$17,500 at Fine Art Auctions Miami's recent Important Paintings and Sculptures sale on April 27, 2013. The Argentine Quin was best known for his geometric painting and collage style, which occasionally incorporated movable pieces and irregularly shaped frames.

ship between the time horizon of a liquidity event and the DLOM. **The shorter the time horizon to a liquidity event, the lower the DLOM.**

A high likelihood that an entity will have some sort of liquidity event, whether by sale or IPO, will: (1) positively impact an interest holder's ability to attract potential buyers and receive a return of its capital investment, and (2) result in a lower estimate of the DLOM. In contrast, the low likelihood of a near-term liquidity event may diminish the attractiveness of the ownership interest to potential buyers and result in a higher estimate of the DLOM.

In instances in which all the other asset features aren't favorable, **having a high probability of a near-term liquidity event may lower the DLOM.** However, the selected DLOM may vary greatly with the expected time to complete the liquidity event.

In the context of charitable giving, the donor has an incentive to contribute an ownership interest in an entity




that has a high probability for a liquidity event. By doing so, the donor can potentially benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction.

Access to Financial Information

Access to entity financial information is often a concern for potential buyers of ownership interests in privately held entities. We classify access to entity financial information as a Tier III asset feature. There's an inverse relationship between the level of access to entity financial information and the DLOM. **Greater access to complete entity financial information generally results in a lower DLOM.**¹⁴

Having greater and more complete access to entity financial information will generally have a positive impact on the marketability of an ownership interest. Greater transparency increases the ability of an interest holder to: (1) evaluate the investment, and (2) attract potential buyers for the ownership interest. The weight placed on this asset feature may be lower than the weight placed on other asset features described above. However, valuation analysts often find that information access is an important investment feature that influences the pool of potential buyers for an ownership interest.

In the context of charitable giving, the donor has an incentive to contribute an ownership interest in an entity that provides the equity holders access to certain entity information. By doing so, the donor can potentially benefit from a relatively higher valuation of the ownership interest and from a higher income tax deduction. 

Endnotes

1. Treasury Regulations Section 1.170A-1(c)(2).
2. Internal Revenue Code Section 170(c)(2)(B).
3. IRC Section 170(f)(11)(C) and IRC Section 170(f)(11)(D).
4. IRC Section 170(f)(11)(E)(i). See also Notice 2006-96 for transitional guidance relating to the definitions of "qualified appraisal" and "qualified appraiser." See also www.irs.gov/irb/2006-46_IRB/ar13.html.
5. IRC Section 170(f)(11)(E)(ii) and (iii).
6. "Clients Donating More To Charity Than Advisors Realize—Advisors Providing Charitable Planning Advice Help Clients Give More; Those Who Don't May be Missing Critical Engagement Opportunity," *Fidelity Charitable* (June 13, 2012), www.fidelitycharitable.org/about-us/news/06-13-2012.shtml.
7. An entity's organizational documents may include the articles of incorporation, bylaws, operating agreement, buy-sell agreements and shareholder agreements.
8. This assumes there are no other factors at play. Other features may influence

the discount for lack of marketability.

9. *Ibid.*
10. A call option with a strike price below fair market value is an in-the-money option from the option holder's perspective.
11. *Supra* note 8.
12. *Ibid.*
13. *Ibid.*
14. *Ibid.*



SPOT LIGHT

Frida Kahlwho?

"Composition, 1916" (7.5 in. by 4.25 in.) by Diego Rivera, recently sold for \$16,250 at Fine Art Auctions Miami's Important Paintings and Sculptures sale on April 27, 2013. Perhaps most notable as Frida Kahlo's husband, Diego Rivera is best known artistically for his large scale wall murals in fresco.