Holman v. Commissioner and the Discount for Lack of Marketability

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This discussion reviews both the Holman v. Commissioner *Tax Court case and the April 7, 2010, Eighth Circuit Court of Appeals affirmation of the* Holman *Tax Court decision. Collectively, the* Holman *decisions provide insight as to how partnership-specific factors affect the valuation discount for lack of marketability. This discussion also summarizes the empirical studies that were used by the valuation analysts in the* Holman *case to support their concluded discounts for lack of marketability.*

Introduction

In *Thomas H. Holman Jr. and Kim D.L. Holman v. Commissioner,*[1] the Tax Court provided insight as to how it viewed the proper valuation of a non-diversified family partnership in the context of gift tax planning. The Eighth Circuit Court of Appeals affirmed the Tax Court's decision.[2]

This discussion provides an overview of the two *Holman* cases, a description of the partnership-specific factors that were considered by the courts in reaching their judicial decisions, and a critique of the discount for lack of marketability that was used in the valuation of the *Holman* partnership's limited partner units.

It is noteworthy that the courts adopted the unusually low discount for lack of marketability that was estimated by the Internal Revenue Service (the "Service) valuation expert. As a result, it is likely that the Service will cite *Holman* in future gift and estate tax cases where it is arguing for a relatively low discount for lack of marketability.

History and Facts of the Case

Thomas H. Holman Jr. and his wife, Kim D. L. Holman (the "Petitioners") created a family limited partnership (the "Holman Limited Partnership" or the "Partnership") on November 2, 1999. Upon creation, the Petitioners were both general partners and limited partners.

The Petitioners cited the following four reasons for forming the Partnership:

1. long term growth
2. asset preservation
3. asset protection
4. education

The goal of asset preservation motivated the Petitioners to include transfer restrictions in the limited partnership agreement. The Petitioners had four minor children at the time that the Partnership was formed.

On November 2, 1999, the Petitioners transferred 70,000 shares of Dell Computer Corporation ("Dell") stock to the Partnership. On that same day, a relative of the Petitioners, as trustee of a trust for the benefit of the Petitioners' children (the "Trust"), transferred 100 shares of Dell stock to the Partnership.

Each contributor received an interest in the Partnership equal to (1) the number of Dell shares contributed by that partner divided by (2) the total number of Dell shares contributed by all of the partners. No distinction was drawn between the general and the limited partner interests.

After the contributions, the Trust held limited partner units that represented 0.14 percent of the total Partnership units. And, the Petitioners held general partner units and limited partner units that

comprised the remaining 99.86 percent of the total Partnership units.

The Partnership, which was formed on November 3, 1999, pursuant to the Holman Limited Partnership agreement, included the following provisions:

- The general partners have exclusive management authority and control over the Partnership business.
- No limited partner is able to withdraw from the Partnership, except as may be provided for in the partnership agreement.
- A limited partner may not assign all or part of his or her interest in the Partnership without the prior written consent of all partners, except as permitted by the partnership agreement.
- A limited partner may assign all of any portion of his or her interest in the Partnership to:
    1. a revocable trust established for the benefit of the partner,
    2. a family member,
    3. a custodian for a family member under an applicable Uniform Transfers to Minors Act (UTMA),
    4. another partner, or
    5. a trustee holding property in trust for family members.
- If an assignment of a Partnership interest occurs or is rendered void by the terms of the partnership agreement, but the general partners determine that such assignment is nevertheless effective according to then applicable law, then the Partnership will have the option (but not the obligation) to acquire the partnership interest of the assignee or transferee upon the terms described in the partnership agreement.
- The Partnership will be dissolved and its affairs will be wound up upon the first to occur of the following:
    1. December 31, 2049,
    2. the written consent of all Partners, or
    3. other events described in the partnership agreement.

Gifts of Partnership Units

The November 8, 1999, Gift

On November 8, 1999, the Petitioners made a gift of limited partner interests ("LP Units") in the Partnership to a family relative (the "Trustee/Custodian") in her capacity as (1) the trustee of the Trust and (2) as custodian for one of the Petitioners' children under the Minnesota UTMA.

After the transfers, the Trust held LP Units that represented 70.2 percent of the total Partnership units. And, the custodian account held LP Units that represented 14.26 percent of the total Partnership units.

For purposes of this transfer, the Petitioners relied on an independent appraisal of the transferred units. The appraiser applied a valuation discount of 49.25 percent to the Partnership's net asset value in reaching his conclusion of the value of one LP Unit as of the date of transfer.

On December 13, 1999, 10,030 shares of Dell stock were transferred to the Partnership from each of three custodial accounts maintained for three of the Petitioners' children. Also on December 13, 1999, 30 shares of Dell stock were transferred to the Partnership from a custodial account maintained for the Petitioners' fourth child. Following these transfers, the Partnership owned 100,220 shares of Dell stock.

The January 4, 2000 Gift

On January 4, 2000, the Petitioners transferred 117,426 LP Units in the Partnership to each of the custodian accounts that were established for the benefit of their children.

After the December 13, 1999, contributions and the January 4, 2000, transfer, the Trust held LP Units that represented 49.10 percent of the total Partnership units. And, each of the four custodian accounts held LP Units that represented 10.83 percent of the total Partnership units.

For purposes of this transfer, the Petitioners relied on an independent valuation of the transferred units. The valuation analyst applied a valuation discount of 49.25 percent to the Partnership's net asset value in reaching his conclusion of the value of one LP Unit as of the date of the transfer.

On January 5, 2001, the Petitioners contributed an additional 10,880 shares of Dell stock to the Partnership, and each contributor received 1,552.07 new LP Units. As a result of these transfers, the Partnership owned 111,100 shares of Dell stock.

The February 2, 2001, Gift

On February 2, 2001, the Petitioners transferred 215,193 LP Units in the Partnership to each of the custodian accounts that were established for the benefit of their daughters.

After the January 5, 2001, contributions and the February 2, 2001, transfer, the Trust held LP

Units that represented 44.29 percent of the total Partnership units. And, each of the four custodian accounts held LP Units that represented 11.13 percent of the total partnership units.

Major Issues in the Case

The Tax Court case involved the following two primary issues that affected the valuations of the transferred LP Units:

- *Application of Section 2703 to Transfer Restrictions in Partnership Agreements.* Does Section 2703 preclude the consideration of transfer restrictions in a partnership agreement when estimating the value of limited partnership interests for gift tax purposes?

  The Tax Court ruled that Section 2703 did apply and, as a result, certain provisions of the Holman partnership agreement are to be disregarded for valuation purposes.

- *Discount for Lack of Marketability.* What is the appropriate lack of marketability discount?

  The Service valuation expert argued that the Holman partners would have an incentive to either dissolve the Partnership or re-purchase the selling partner's interest at a price between (1) pro rata net asset value (NAV) and (2) the value that a third party would pay for the interest.

  The Tax Court accepted this argument, which appears to violate the strict form of the hypothetical willing buyer/willing seller valuation standard and also go against the observed history of the Partnership. In doing so, the Tax Court adopted the Service valuation expert's concluded discount for lack of marketability of 12.5 percent.

Appeals Court Holdings

By a majority opinion (a 2-1 split of the three-judge panel), the Eighth Circuit affirmed the following Tax Court findings:

- Transfer restrictions in the partnership agreement are disregarded for valuation purposes under Section 2703(a), and the Section 2703(b) safe harbor does not apply. This is because the bona fide business arrangements requirement was not satisfied.
- The 12.5 percent discount for lack of marketability was based, in part, on the notion that the ability of the remaining partners to purchase assigned interests sets a natural limit on any valuation discounts. The Appeals Court concluded that this did not violate the hypothetical willing buyer/willing seller valuation standard because it "comports with the general rule of casting the potential buyer merely as a rational economic actor."

The dissenting judge strongly disagreed with both of these holdings and would have reversed and remanded to the Tax Court for a new discount for lack of marketability determination.

It is also noteworthy that the Court's majority viewed the discount for lack of marketability as an issue of fact subject to a clear error review standard rather than an issue of law that should be reviewed de novo.

The dissenting judge strongly disagreed with this conclusion, stating that the determination of fair market value is an issue of fact but stating that the "determination of the appropriate valuation method is an issue of law" that should be reviewed de novo.

Discount for Lack of Marketability Issue in the Case

One of the most important outcomes of this case is that the Service now has an argument for a relatively low valuation discount for lack of marketability. The concluded 12.5 percent discount is outside of the range of discounts that is provided by most studies on the discount for lack of marketability. The concluded discount is also lower than the lack of marketability discount that has resulted from many judicial decisions.

As such, valuation analysts should be prepared to defend their valuation discount conclusion by having a firm understanding of the studies on which the discount for lack of marketability is based.

The following discussion presents (1) a summary of the discount for lack of marketability data that were used by the Service valuation expert in the *Holman* case and (2) a review of the underlying restricted stock studies from which these conclusions were reached.

Service Valuation Expert's DLOM Analysis

Given the lack of a ready market for the Partnership LP Units, both parties agreed that a discount for

Exhibit 1
The *Holman* Cases
Summary of Restricted Stock Study Data Used by the Service Valuation Expert

Restricted Stock Study Time Period	Significant Characteristics of the Time Period	Indicated Average or Median DLOM
Stock Transactions before 1990	Sales prior to SEC Rule 144A. Sales are subject to a 2-year holding period	34%
Stock Transactions from 1990 to 1997	Sales after adoption of SEC Rule 144A, but before the reduction of the required holding period from 2 years to 1 year	22%
Stock Transactions during 1997 and 1998	Sales after the reduction of the required holding period to 1 year	13%

lack of marketability (DLOM) should be applied in valuing the Partnership LP Units.

In supporting his selected DLOM, the Petitioners' valuation expert relied on empirical data presented in studies of restricted stock transactions. Considering these data, and the specific characteristics of the LP Units, the Petitioners' valuation expert arrived at a DLOM of 35 percent for the LP Units.

In estimating his DLOM, the Service valuation expert also relied on empirical data presented in studies of restricted stock transactions. He segregated these studies into three different groups based on the dates of the restricted stock transactions included in each study, as summarized in Exhibit 1.

In analyzing the data presented in Exhibit 1, the Service valuation expert came to the conclusion that (1) limited access to a liquid market and (2) a required holding period prior to the restricted stock becoming freely traded, both influence investor behavior.

The valuation expert also explained how, in his view, the adoption of Rule 144A—which allowed for the institutional trading of restricted stock—created a market for restricted stock. Prior to 1990, no such resale market existed.

The Service valuation expert suggested that the difference between the average discount of (1) the pre-1990 transactions of 34 percent and (2) the 1990 and 1997 transactions of 22 percent—or 12 percent—reflects the discount that investors in restricted stocks required for having virtually no secondary market.

In other words, the Service valuation expert suggested that prior to 1990, purchasers of restricted stock demanded, on average, an additional discount of 12 percent to account for the purchaser's lack of access to a ready resale market. In transactions prior to 1990, the Service valuation expert further concluded that the remaining 22 percent discount (i.e. 34 percent less 12 percent) is attributed to (1) holding period restrictions and (2) factors unrelated to marketability.

Further, the Service valuation expert suggested that the decrease in the average discount from (1) 22 percent (i.e., the 1990 to 1997 transactions) to (2) 13 percent (i.e., the 1997 to 1998 transactions) is attributed to the reduction in the required holding period from two years to one year.

The Service valuation expert concluded that investments such as the LP Units, which are not subject to a mandated holding period and other operating and financial risks, warrant a DLOM of 12 percent.

In selecting a DLOM for the LP Units, the Service valuation expert also considered the specific characteristics of the Partnership. These characteristics included:

1. its lack of distributions,
2. its nondiversified portfolio,
3. the transferability restrictions on the LP Units,
4. the dissolution provisions of the Partnership agreement, and
5. the liquidity of the Dell stock owned by the Partnership.

More specifically, the Service valuation expert believed that the provisions of the Partnership agreement, which provide for a voluntary dissolution of the Partnership and a pro rata distribution of the Partnership assets, benefited a holder of LP Units.

In arguing for a relatively low DLOM, the Service valuation expert stated that a voluntary dissolution of the Partnership would be of little detriment to the remaining partners. This is because the remaining partners could reconstitute the Partnership without the withdrawing partner, and the dissolution would benefit the withdrawing partner.

The Service valuation expert further opined that due to the liquid nature of the Partnership assets, a reasonable negotiation between a buyer and seller

over the price of an LP Unit would result in a price concession for lack of marketability in the range of 10 to 15 percent.

Based on the restricted stock data included in Exhibit 1 and the various Partnership-specific factors, the Service valuation expert concluded a DLOM for the LP Units of 12.5 percent. The Tax Court agreed with the Service valuation expert on this issue and adopted the 12.5 percent lack of marketability discount that he suggested. The Appeals Court affirmed this decision.

Many in the valuation profession would argue that the Service valuation expert's analysis and determination of a 12.5 percent discount for lack of marketability appeared flawed in its interpretation of the restricted stock study data.

As the taxpayer's brief points out, "although the prohibition against trading restricted shares in the public market will expire at the end of the relevant holding period, interests in the Partnership can never be sold in the public market or marketed to the public without registration under the federal and state securities laws."

Given that the Service valuation expert based his discount for lack of marketability on restricted stock study data, a summary of the historical restricted stock study data is warranted.

Restricted Stock Study Data

Publicly traded companies may raise capital by completing a private placement of debt or equity securities. In an equity private placement, a company can issue either registered stock or unregistered (i.e., restricted) stock to an accredited investor.

Registered stock includes the shares of publicly traded companies that can be freely traded in the open market. Unregistered shares of stock are not registered for trading on a stock exchange. Unregistered shares cannot be freely traded in the open market.

When publicly traded companies issue restricted (unregistered) stock, the restricted stock is typically sold at a price discount compared to the price of the (registered) publicly traded stock. Companies are willing to accept a price discount on the sale of their restricted stock. This is because the time and cost of registering the new stock with the SEC would make the stock issuance/capital formation impractical.

These observed price discounts (i.e., public stock price compared to same company private stock price) indicate a DLOM.

SEC Rule 144[3] governs the purchase and sale of stock issued in unregistered private placements. According to the SEC, "When you acquire restricted securities or hold control securities, you must find an exemption from the SEC's registration requirements to sell them in the marketplace. Rule 144 allows public resale of restricted and control securities if a number of conditions are met."[4]

The conditions mentioned in SEC Rule 144 relate to the following:

1. investment holding period
2. adequate current information
3. a trading volume formula
4. ordinary brokerage transactions
5. filing of a notice with the SEC

The investment holding period restrictions on the transfer of restricted stock eventually lapse, usually after 12 months.[5] At that point, the trading volume formula is typically the most restrictive sale condition of SEC Rule 144. The trading volume formula allows the subject securities to be "dribbled out" in the marketplace.

Depending on the size of the block of the subject securities, the dribble-out formula may require the investor to sell small portions of the subject securities over a multi-year period. Rather than dribble out the sale of the restricted securities, the owner of restricted stock can also sell his or her securities in a privately negotiated transaction, subject to the Securities Act of 1933, Section 4(1) and Section 4(2).

Until 1995, restricted stock sale transactions had to be reported to the SEC. Therefore, such restricted stock sale transactions were a matter of public record. Since 1995, analysts have collected restricted stock sale transaction data from private sources.

Therefore, a body of data is available on the prices of private transactions in restricted securities. These transaction price data can be used for comparison with prices of the same company unrestricted securities eligible for trading on the open market.

The following restricted stock studies cover several hundred transactions spanning the late 1960s through 2008. The results of these various restricted stock studies are summarized in Exhibit 2.

These restricted stock studies have generally concluded a decrease in the average DLOM after 1990. The restricted stock transactions analyzed in the studies covering the 1968 to 1988 period (where the average DLOM was approximately 35 percent) were generally less marketable than the restricted stocks analyzed after 1990 (where the average DLOM ranged between 20 percent and 25 percent).

Exhibit 2
Restricted Stock Studies
Summary of Observed Price Discounts

Restricted Stock Study	Observation Period of Study	Observed Average Price Discount
SEC Overall Average	1966–69	25.8%
SEC Nonreporting OTC Companies	1966–69	32.6%
Milton Gelman	1968–70	33.0%
Robert R. Trout	1968–72	33.5%
Robert E. Moroney	1969–72	35.6%
J. Michael Maher	1968–73	35.4%
Standard Research Consultants	1978–82	45.0%
Willamette Management Associates	1981–84	31.2%
Hertzel & Smith	1980–87	13.5%
William L. Silber	1981–88	33.8%
Baja, Denis, Ferris, and Sarin [a]	1990–95	22.2%
Johnson Study	1991–95	20.0%
Management Planning, Inc.	1980–96	27.0%
FMV Opinions, Inc.[b]	1980–08	21.2%
Columbia Financial Advisors, Inc.	1996–97	21.0%
Columbia Financial Advisors, Inc.	1997–98	13.0%
LiquiStat	2005–06	32.8%

[a] This study attributes price discount to factors other than marketability (i.e., compensation for the cost of assessing the quality of the firm and for the anticipated costs of monitoring the future decisions of its managers.

[b] Represents results of latest published study. The database is routinely updated and available for purchase at www.bvmarketdata.com.

Valuation analysts typically attribute this decrease in observed price discounts to:

1. the increase in volume of privately placed stock under SEC Rule 144(a) and
2. the change in the minimum SEC-required holding period under Rule 144—from two years to one year—that took place as of April 29, 1997.[6]

Increased volume was the result of a Rule 144 amendment in 1990 that allowed qualified institutional investors to trade restricted securities among themselves. By increasing the potential buyers of restricted securities, the marketability of these securities generally increased.

Both of these explanations suggest that investors have not changed the way they value marketability. Rather, the marketability of restricted securities has increased. As it became easier to find a buyer for restricted securities after 1990, the average restricted stock price discount decreased. The same trend occurred after the SEC-required holding period decreased from two years to one year in 1997.

On December 17, 2007, the SEC issued revisions to Rules 144 and 145.[7] The revisions included shortening the holding period requirement for restricted securities of issuers that are subject to the reporting requirements of the Securities Exchange Act of 1934 ("reporting companies") from one year to six months.

The revisions state that, "Under the amended Rules 144, after six months, if the issuer is a reporting company, . . . nonaffiliates may sell restricted securities without further limitations, including manner-of-sale or volume limitations.[8]

The holding period remains at one year for nonreporting issuers. This amendment became effective February 15, 2008. Thus far, only the FMV Study (referenced in Exhibit 2) includes any transactions subject to the six-month holding period.

As the market for restricted stocks has evolved and become more liquid, it is increasingly important for valuation analysts to consider the facts and circumstances of each restricted stock study.

In particular, it is important to compare the market for the subject closely held company with the market for restricted securities. If the expected holding period for the stock in a closely held company is two years or greater, it may be more meaningful to select a DLOM based on the restricted stock studies conducted prior to 1990 (in addition to considering other theoretical and empirical research).

Alternatively, if the subject closely held stock is likely to be liquidated within six months or one year, the post-1990 studies may be more meaningful.

It appears that the Service valuation expert and the Courts largely ignored these holding period considerations when selecting a DLOM for the LP Units.

Summary and Conclusion

The Tax Court's decision and the Appeals Court's affirmation of *Holman* are still favorable to the Petitioner in a few respects. The Courts held that the gifts of LP Units were not viewed as indirect gifts of the Dell shares to the donees.

Also, valuation discounts were allowed, although the discounts were only 22 percent, 25 percent, and 16.25 percent for the three respective transactions.

It is noteworthy that the Tax Court fully adopted the Service valuation expert's DLOM estimate, which basically ignored the relationship between the expected holding period of a security and its DLOM. It is also noteworthy that the Appeals Court did not find that this was a matter for de novo review.

The studies cited in this discussion support, quite consistently, that there exists a high correlation between the expected holding period of a security and its DLOM.

Restricted shares of public corporation stock may not (temporarily) be traded directly on a stock exchange. However, the investor has certainty that, in a relatively short time period, the trading restrictions will lapse.

The shares of stock of a closely held corporation, on the other hand, may never be traded directly on a stock exchange. The prospect of any level of efficient marketability is much lower for closely held company shares compared to restricted public company shares.

Therefore, the appropriate DLOM related to closely held corporation shares (or to similar closely held investments) is generally considered to be greater than the DLOM indicated by restricted stock studies.

Notes:

1. *Holman v. Commissioner*, 130 T.C. No. 12 May 27, 2008).
2. *Holman v. Commissioner*, 105 AFTR 2d Section 2010-721 (8th Cir. April 7, 2010) aff'g 130 T.C. 170 (2008).
3. 17 CFR 230.144 (revised April 1, 1990).
4. SEC Website: http://www.sec.gov/investor/pubs/rule144.htm.
5. On February 18, 1997, the SEC adopted amendments to reduce the holding period requirements under Rule 144 of the Securities Act from two years to one year for the resale of limited amounts of restricted securities (the amendment became effective April 29, 1997).
6. See, for example, "Restricted Stock Discounts, 1991–95," Bruce Johnson, *Shannon Pratt's Business Valuation Update*, March 1999; Rod Burkert, "Cure for Declining Discounts, Deconstruct the Studies," *Trusts & Estates*, March 2004; and Robert Reilly, "Willamette Management Associates' Discount for Lack of Marketability Study for Marital Dissolution Valuations," *American Journal of Family Law*, Spring 2005.
7. 17 CFR Parts 230 and 239, December 17, 2007.
8. John A. Menicucci Jr., "SEC Adopts Amendments to Rule 144 & Rule 145." *The Nebraska Lawyer*, April 2008.

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This article from which this discussion was adapted, was originally published in the Autumn 2008 issue of Willamette Management Associates Insights.

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Valuation analysts are often engaged to value one percent ownership interests in business entities. Even though the step transaction doctrine was invoked in Pierre I and II, the difference between (1) the valuation discount applied to a 1 percent ownership interest and (2) the valuation discount applied to a 50 percent ownership interest was immaterial.

However, in other transactions where (1) the step transaction doctrine is applied and (2) the resulting transferred ownership interest has increased elements of ownership control, the decrease in the concluded valuation discount could be substantial.

Accordingly, taxpayers and their estate planners and valuation advisers should consider how owernship control changes between the two steps of a so-called step transaction.

Notes:

1. *Pierre v. Commissioner*, T.C. Memo 2010-106 (May 13, 2010).
2. Combining a 10 percent DLOC and a 30 percent DLOM results in a combined valuation discount of 37 percent. However, the appraiser made an error and applied a combined DLOC and DLOM of 36.55 percent
3. *Pierre v. Commissioner of the Internal Revenue Service*, 133 T.C. No. 2 (2009).
4. *Pierre v. Commissioner*, T.C. Memo 2010-106 (May 13, 2010).
5. Ms. Pierre filed Form 8832, Entity Classification Form, to elect not to treat Pierre LLC as a corporation.
6. *Commissioner v. Clark*, 489 U.S. 726 (1989).
7. Holman v. Commissioner, 130 T.C. 170 (2008).
8. *Gross v. Commissioner*, T.C. Memo 2008-221 (Sept. 29, 2008).
9. *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006).
10. *Estate of Cidulka v. Commissioner*, T.C. Memo 1996-149 (Mar. 25, 1996).
11. *Shepard v. Commissioner*, T.C. Memo 2004-160 *aff'd*. 433 F.3d 1044 (8th Cir. 2006).

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