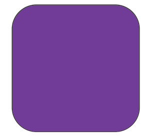

CONSIDERING A DLOC IN THE CONSTRUCTION COMPANY TRANSFER TAX VALUATION

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

ROBERT F. REILLY

Private construction company owners — or their tax counsel — often retain specialized valuation analysts to value their private companies, private company ownership interests, and private company securities for tax purposes. These tax purposes can involve gift tax, estate tax, and generation-skipping transfer tax (collectively referred to here as transfer tax). Such transfer tax valuations could be performed for purposes of tax planning, tax compliance (including gift or estate tax return preparation), Internal Revenue Service audit support, and tax litigation (including testifying expert services).

To develop such a transfer tax–related valuation, the analyst has to understand the subject construction company ownership interest; that is, the analyst must know if the valuation subject is the entire private company (a corporation, partnership, limited liability company, etc.), a particular ownership interest in the construction company, (e.g., a 50 percent ownership interest), or a particular security in the construction company (e.g., 1,000 shares of the company's Class B nonvoting common stock).

The analyst must also know the legal ownership interest subject to the transfer tax valuation. He or she should be instructed, usually by the tax counsel, 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 (usually by the company owner) as to whether the valuation subject is encumbered by a shareholders' agreement, a buy/sell agreement, or any other contractual provisions that would restrict transferability or otherwise impact the company/security value.

The analyst must be instructed as to the appropriate valuation date, typically the date of ownership transfer for transfer tax purposes. The analyst must be instructed as to the appropriate standard or definition

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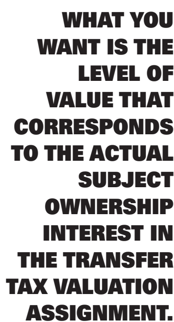
of value to conclude. For transfer tax purposes, the appropriate standard of value is typically fair market value, and the analyst must be informed as to the appropriate premise of value. For transfer tax purposes, the typical premise of value regarding a private construction company business ownership 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 construction company's operating assets. It is possible that the HABU of the private construction company would be reflected by the valuation premise of value in exchange, or value as part of an orderly disposition of the company's assets.



WHAT YOU WANT IS THE LEVEL OF VALUE THAT CORRESPONDS TO THE ACTUAL SUBJECT OWNERSHIP INTEREST IN THE TRANSFER TAX VALUATION ASSIGNMENT.

Levels of value

Finally, the analyst should consider the appropriate level of value to apply in the transfer tax valuation. The concept of level of value is sometimes overlooked by the company owner or the owner's tax planner — or even by the owner's tax counsel. However, the concept of level of value is not overlooked by the IRS 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 includes two primary considerations: (1) the marketability of the subject ownership interest and (2) the ownership control attributes of the subject ownership interest.

As a simplified introduction to these two considerations, the marketability consideration involves how easy it is for the owner to sell the subject ownership interest 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 private construction company.

As will be discussed later, the ownership attributes of marketability and operational control are not absolute considerations. Rather, these two ownership attributes are each represented by a continuum. That is, ownership interests are typically not perfectly marketable, and they are not perfectly nonmarketable; instead, 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 to conclude a value indication of another (i.e., the intended) level of value. For example, the valuation analyst may conclude the value of the private construction company ownership interest on a marketable basis, but the appropriate level of value is a nonmarketable basis. Likewise, the valuation analyst may conclude the value of the private construction company ownership interest on a controlling basis, but the appropriate level of value is a noncontrolling basis. In such situations, the analyst must account for that difference in ownership attributes and in value.

To account for these differences in ownership attributes, the analyst will apply a "valuation adjustment." A valuation adjustment can involve the application of either a valuation premium (i.e., an incremental value adjustment) or a valuation discount (i.e., a decremental value adjustment). Applying a valuation adjustment gets you from "what you have" to "what you want." 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 particular 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 later, the requirement for such a valuation adjustment is created by the fact that some generally accepted business valuation approaches and methods typically conclude a particular 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 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 the private construction company. That is, the analyst applied the valuation adjustment 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 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 to conclude a meaningful value conclusion. The analyst's considerations related to the application of a DLOC in the transfer tax valuation is the subject of this discussion.

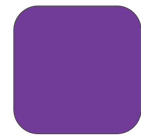
The difference in the price that a willing buyer would pay for a controlling ownership interest compared to an otherwise comparable noncontrolling ownership interest may represent a material value adjustment. This price difference is often referred to as the DLOC, which measures the difference between the price that a willing buyer would pay for a private company controlling ownership interest and the price that a willing buyer would pay for an otherwise identical private company noncontrolling business ownership interest.

This discussion summarizes the concept of ownership control in a transfer tax valuation, the reasons why analysts apply a valuation adjustment (i.e., a price discount or a price premium) in a private construction company business valuation, the theoretical models and the empirical studies that analysts typically consider to measure the amount of any DLOC, and 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 construction company lacks many so-called perquisites of ownership and has little or no control over the private construction company's operating, investing, and financing activities. A willing buyer considering 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 construction company by exercising what are often called the prerogatives of control. This nonexhaustive list indicates some typical prerogatives of ownership control regarding the operation of a private company:

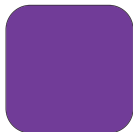
1. ability to select the management of the company;
2. ability to determine management compensation, including bonuses, and other employment-related perquisites;
3. ability to set operational and strategic policy and to change the course of the company's business operations;
4. ability to acquire and/or 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 financing transactions on the behalf of the company;
7. ability to liquidate, dissolve, sell, or recapitalize the company or to enter 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; and
10. ability to enter leases, licenses, or other contracts, including entering self-dealing contracts.



SOME GENERALLY ACCEPTED BUSINESS VALUATION APPROACHES AND METHODS CONCLUDE A CONTROLLING OWNERSHIP INTEREST LEVEL OF VALUE.

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 construction company is derived from the controlling owner's ability to exercise those prerogatives of ownership control to generate economic benefits that would be greater than the economic benefits generated under the company's current stewardship.[1]

Consequently, 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 to achieve incremental economic benefits.[2] In general, such economic benefits can be accomplished by 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 decreasing the investor's required rate of return on investment in the subject company (i.e., by decreasing either the company's overall cost of capital or the risk of the business interest investment to the controlling owner).



THE ANALYST SHOULD CONSIDER WHAT LEVEL OF VALUE WAS CONCLUDED FROM THE APPLICATION OF EACH VALUATION METHOD BEFORE CONSIDERING THE APPLICATION OF A DLOC.

If the private construction company is already 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 on the analyst to consider whether a change of control transaction could result in increased cash flow (either to the private company overall or redirected cash flow to the control owner) and/or decreased required rate of return on investment for the subject ownership interest (either decreased risk to the private company overall or decreased risk solely to the control owner). 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 them to identify the specific factors that would support that conclusion.

Another factor that the analyst would consider when deciding whether 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 the application of each valuation method before considering the application of a DLOC.

For example, 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 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 called the guideline transaction method) typically concludes a value indication on a controlling ownership interest level of value basis. In that case, it may be fitting 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 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 construction company is typically a three-step process. The first step in this process is for the analyst to determine whether the valuation method applied develops a value indication that concludes a controlling or noncontrolling ownership interest level of

value. Depending both on the level of value of the valuation subject ownership interest and 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 must 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 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 the fair market value of a noncontrolling ownership interest and the fair market value of a controlling ownership interest.

The third step is for the analyst to determine the magnitude of any incremental economic benefits available to the control owner 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 construction company. The greater investment risk stems from the noncontrolling interest holder's inability to exercise the prerogatives of ownership control and the potential for the controlling interest holder to make decisions and 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. However, as described previously, the magnitude of the difference in investment risk, and its impact on the subject interest's fair market value, can vary greatly depending on the specific factors related to the subject ownership interest and the subject private construction company.

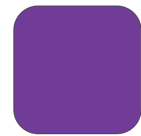
Theoretical methods to quantify the DLOC

Application of the DCF 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 construction company, equals the present value of future income expected to be generated by that company or that ownership interest. As a result, 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 some or all of the prerogatives of ownership control. This increase in economic benefits to the control owner can be accomplished by increasing the company's total cash flow or the control owner's specific cash flow and/or decreasing the company's — or the control owner's — required rate of return on investment.

Regarding a DLOC, the analyst may apply a functional analysis to determine whether a change of control transaction could enhance the company's — or the control owner's — cash flow or decrease the required rate of return on investment. To make this determination, the analyst may develop a DCF valuation analysis by applying financial projections from a noncontrolling ownership interest perspective and another DCF valuation analysis by applying financial projections from a controlling ownership interest perspective and then compare the two value indications provided by the analyses. This comparison should help the analyst to determine the value adjustment (i.e., price discount) attributable to a lack of ownership control or the price premium attributed to ownership control.

It is significant that, if the analyst can estimate a value conclusion for both a noncontrolling level of value DCF valuation analysis and a controlling level of value DCF valuation analysis, then the resulting value conclusions likely do not need to be adjusted further for ownership control attributes. That is, if the transfer tax valuation objective is to estimate the fair



THE INVESTMENT RISK OF A NONCONTROLLING OWNERSHIP INTEREST IS TYPICALLY GREATER THAN THE INVESTMENT RISK OF A CONTROLLING OWNERSHIP INTEREST IN THE SAME PRIVATE CONSTRUCTION COMPANY.

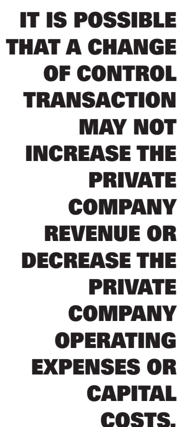
market value on a noncontrolling ownership interest basis, and if the DCF valuation analysis develops a noncontrolling ownership interest level of value, then it is not necessary to apply an additional DLOC to that value indication.

However, the analyst may compare the two value indications developed by the two DCF valuation analyses 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 DCF model. As previously discussed, the analyst will typically 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; and
4. capital expenditure efficiencies.

It is also noteworthy that many of these economic benefits may not be achieved through a change of control transaction. The achievement of these economic benefits is often contingent on the new controlling owner having access to alternative markets, commercializing alternative production and supply channels, or exploiting post change of control event synergies or economies of scale. In those cases, it is important for the analyst to distinguish between the economic benefits that would be attributable to synergies that a specific new control owner may be able to achieve and 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 INCREASE THE PRIVATE COMPANY REVENUE OR DECREASE THE PRIVATE COMPANY OPERATING EXPENSES OR CAPITAL COSTS.

It is possible that a change of control transaction may not increase the private company revenue or decrease the private company operating expenses or capital costs. If the private construction company is already operating 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.

This 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 sources of capital; and
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, 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 investment risk — and reduce 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 or decreased investment risk, either to the company or to the control owner. The analyst should consider the possibility of achieving the previously listed results, as well as other company-specific factors discussed later, 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 this nonexhaustive list of company-specific factors when deciding whether the application of a DLOC is appropriate to the transfer tax valuation:

1. the current stage of the private construction company's life cycle;
2. the quality of the construction company's management;
3. the level of the company's management compensation;
4. the company's capital structure;
5. the current management's goals and objectives;
6. the regulatory risk factors in the construction company's industry segment; and
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 for the transfer tax valuation.

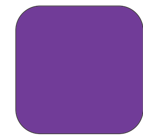
Empirical studies to quantify the DLOC

The analyst may determine that a DLOC is applicable based on the business valuation approaches and methods applied and the company-specific factors already described. Based on that judgment, 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 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 quantify the DLOC for a noncontrolling ownership interest in a private construction 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) and (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 studying 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, with the median tender offer price premium typically ranging from approximately 25 to 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 an acquisition price premium of more than 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 to 40 percent is mathematically equivalent to a preacquisition price discount of approximately 20 to 29 percent. (The DLOC price discounted is calculated as: 1 – [1/(1 + control price premium)].)



THE ACQUISITION PRICE PREMIUMS REPORTED IN EMPIRICAL STUDIES OF PUBLIC COMPANY ACQUISITION TENDER OFFERS OFTEN INCLUDE CONSIDERATION PAID BY THE ACQUIRER FOR EXPECTED POSTMERGER SYNERGISTIC VALUE.

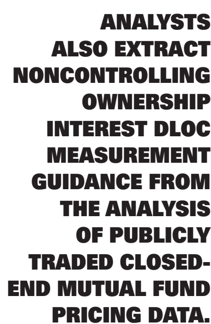
It is noteworthy that the acquisition price premiums reported in empirical studies of public company acquisition tender offers often include consideration paid by the acquirer for expected postmerger synergistic value. All things considered, the presence of expected postmerger synergistic value would 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 of the corresponding DLOC. Alternatively, the analyst may attempt to disaggregate the total acquisition price premium data into two price premium components: the control price premium component and the synergistic price premium component.

The analyst may apply judgment to remove the impact of consideration for synergistic price premiums from the indicated total acquisition price premium data. To do so, the analyst often attempts to distinguish — or allocate — between the

portion of the total acquisition price premium that relates to a control price premium only and the portion of the total acquisition price premium that relates to a synergistic price premium.

Some procedures that the analyst may consider to make such an adjustment to, or allocation of, the tender offer acquisition price premium data includes 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 focus 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).



ANALYSTS ALSO EXTRACT NONCONTROLLING OWNERSHIP INTEREST DLOC MEASUREMENT GUIDANCE FROM THE ANALYSIS OF PUBLICLY TRADED CLOSED-END MUTUAL FUND PRICING DATA.

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

To illustrate the application of this default rule of thumb, consider this simplified example. 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 the appropriate construction segment Standard Industrial Classification (SIC) code or industry segment group. These data would relate to the acquisition of public companies of a size that would provide meaningful pricing guidance to the analyst. These public company going-private acquisitions would also have been completed during a time that would be relevant to the subject valuation date.

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 more than 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 postmerger synergies (not solely related 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. Essentially, the analyst may assume that the control price premium component of the total price premium was 20 percent.

The analyst must still convert this assumed control price premium into a DLOC percentage. As previously mentioned, 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. 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, the shareholder is unable to exercise control over the fund's investment portfolio. Similarly, in a private construction company, typically the noncontrolling shareholder is unable to exercise the prerogatives of ownership control to influence the operations of the private company.

Analysts often consider the research regarding the reasons many closed-end

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 Private, LLC, Total Equity	$100.0
Multiplied by: Tom Taxpayer Estate LLC Units Percentage Ownership	25%
Fair Market Value Indication of the Estate Ownership—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

mutual funds typically trade at a price discount to net asset value. Some reasons that have been suggested in the research are:

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 mutual fund; and
6. lack of diversification of the mutual fund's investment portfolio.

As intuitive as some of these 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 construction company in many respects. A noncontrolling private company owner is in no position to influence the private company management and is dependent on the decisions made by the controlling owner. Similarly, for a noncontrolling owner of a closed-end fund, a closed-end fund shareholder is not in a position to influence the management of the mutual fund portfolio and is 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 an explanation as to why a DLOC may be applicable to the valuation of the private company business interest or of the closed-end mutual fund shares.

It is generally accepted that the observed closed-end fund price discount data provide guidance regarding a DLOC and not a DLOM. 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. First, assume that Thomas D. Taxpayer owned 25 percent of the limited liability company (LLC) membership units of Private Construction Company, LLC (Private, LLC). Tom Taxpayer passed on September 30, 2020, and accordingly, his private company business ownership interest is included in his estate.

In this example, tax counsel for the Tom Taxpayer 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 Private, LLC owners' equity.

The analyst applies generally accepted business valuation approaches and methods. The analyst develops 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 also develops a market approach and GMAC method value indication by analyzing recent sale transactions of comparable construction companies. Finally, the analyst develops an asset-based approach and asset accumulation method value indication by estimating the current market value of all the construction 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 concludes that the fair market value of 100 percent of the Private, LLC owners' equity was $100 million, as of September 30, 2020. Tom passed owning 25 percent of the construction company's LLC units; therefore, the unadjusted fair market value of the ownership interest in Tom's estate appears to be $25 million.

PRIVATE CONSTRUCTION COMPANY OWNERS AND THEIR TAX COUNSEL OFTEN CALL ON SPECIALIZED VALUATION ANALYSTS TO ESTIMATE THE FAIR MARKET VALUE OF A BUSINESS OWNERSHIP INTEREST FOR TRANSFER TAX PURPOSES.

The $100 million fair market value conclusion may be appropriate for the entire business of Private, LLC. If there were four equal partners (members) who owned Private, LLC, including the executor of Tom's estate, and they decided to sell Private, LLC, they would expect to receive $100 million in total sale price consideration for the sale of the entire company. However, this transaction represents the transfer of a marketable, controlling ownership interest in the construction company. Collectively, all four members can decide to sell Private, LLC and thereby make it marketable. All four members would transfer control of the total company to the new owner, such as a corporate acquirer. Therefore, the $100 million transaction price represents the value of a marketable, controlling ownership interest in Private, LLC.

Tom's estate, however, 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 LLC 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 to conclude the fair market value of the estate's ownership interest. Assume that the analyst selects a 30 percent DLOM.

Then the analyst considers control price premium indications extracted from sale price data related to recent public construction company going-private acquisitions. Additionally, the analyst considers stock market price data related to publicly traded mutual fund stock price to net asset value discounts. Finally, the analyst considers the actual management structure, corporate governance practices, company results of operations, and equity ownership allocation of Private, LLC. Based on these factors, assume that the analyst selects a 20 percent DLOC as appropriate for the estate's ownership interest in Private, LLC, units.

Based on this 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 a $14 million ownership interest value for transfer tax purposes.

Summary and conclusion

Private construction company owners and their tax counsel often call on specialized valuation analysts to estimate the fair market value of a business ownership interest for transfer tax purposes. Such a business ownership interest may include a private construction company, an ownership interest in such a company, and the debt and equity securities of such a company. The transfer tax at issue may be a gift tax, estate tax, or generation-skipping transfer tax. Such a valuation may be performed for tax planning, compliance, audit support, or litigation purposes.

One factor that the analyst should consider in the transfer tax valuation of the private construction company business interest is the level of value. The business ownership interest's level of value is primarily described by two elements: marketability and control.

The analyst should assess where the subject business interest falls in the continuum ranging from perfectly marketable to perfectly nonmarketable. The analyst should also assess where the subject business interest falls in the continuum ranging from total ownership control to a total lack of ownership control.

Some 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 approach and 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.

To get from what you have (i.e., a controlling interest level of value indication) to what you want (i.e., a noncontrolling interest level of value conclusion), the analyst typically will 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 account for all 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 these factors, the analyst may determine that a change of control transaction could result in increased cash flow to the private company/control owner or a decreased required rate of return on investment to the private company/control owner. In such a situation, there may be a difference between the value of a noncontrolling ownership interest in the private construction company and the value of a comparable controlling ownership interest in the private construction 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 the controlling ownership interest level of value for the subject business interest and the noncontrolling ownership interest level of value for the subject business interest. In such a case, 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] "Valuations in financial reporting valuation advisory 3: The measurement and application of market participant acquisition premiums," The Appraisal Foundation (2017) (report). Available at: https://appraisalfoundation.sharefile.com/share/view/sa5378ae8f7541ba9.

[2] *Ibid.*