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ESTATE OF KELLY V. COMMISSIONER, T.C. MEMO, 2005-235 OCTOBER 11, 2005

This case was about the application of discounts for lack of control and lack of marketability. The Estate of Kelley had ownership interests in two limited liability companies. The first was an investment holding company known as Kelley-Louden, Ltd. ("KLLP"), which held assets totaling $1,226,421, which consisted of $807,271 cash and $419,158 in certificates of deposit. The second company was Kelley-Louden Business Properties, LLC ("KLBP LLC") whose only asset was a 1% interest in KLLP. Both sides agreed that the value of KLLP's assets as of the valuation date was $1,226,421. Therefore, this case is focused on the applicable discounts to this net asset value ("NAV").

DISCOUNT FOR LACK OF CONTROL

The expert witnesses for both the IRS and the Estate utilized information from general-equity closed end funds to determine the appropriate discount for lack of control to apply to the NAV. They both also divided the comparable closed-end funds into quartiles by price to NAV ratios. The first quartile represented the funds that were in high demand and therefore traded at low discounts or premiums. The fourth quartile represented the funds that were in low demand and therefore, traded at higher discounts.

Using several factors in making his determination, the Estate's expert determined that KLLP was more similar to the closed-end funds in the fourth quartile which had discounts to NAV ranging from 21.8% to 25.5%. He then further adjusted the discount by analyzing data from two other partnership studies. The first study, by Partnership Profiles, Inc., found that the average discount for 18 publicly registered but nontraded miscellaneous partnerships was 29%. The other study also published by Partnership Profiles, which included 100 publicly registered but nontraded real estate partnerships, resulted in an average discount of 27%. Therefore the Estate's expert witness used a 25% discount for lack of control.

The Commissioner's expert witness used the arithmetic mean of the entire set of closed-end funds, not just the fourth quartile. This resulted in a discount for lack of control of 12%.

The court was not persuaded by the Estate's expert witness to use just the fourth quartile of the closed-end funds. They state that, "While we have utilized small samples in other valuation contexts, we have also recognized the basic premise that '[a]s similarity to the company to be valued decreases, the number of required comparables increases."[1] The court also states that by using just the fourth quartile of funds that the expert has combined elements of the discount for lack of marketability with the discount for lack of control since these funds had the lowest demand and therefore the highest marketability discount.

They were also not persuaded by the Estate's expert use of the Partnership Profile studies since these studies contain some element of discount for lack of marketability and therefore overstate the discount for lack of control.

The court states that while neither expert was particularly persuasive, that a 12% discount would be utilized since the Estate's expert was not able to convince the court that a higher discount would be appropriate.

DISCOUNT FOR LACK OF MARKETABILITY

In determining the marketability discount, the Estate's expert used the restricted stock approach and drew an analogy between the partnership interests in KLLP and the common stock of a private closely-held corporation. The expert also reviewed the many barriers to marketability of a limited partnership interest in KLLP. After considering all the factors, the Estate's expert determined that the discount for lack of marketability should be 38%.

The Commissioner's expert used the private placement approach. This approach is a variant of the restricted stock approach and attempts to isolate the effect that impaired marketability has on the discount determined under the restricted stock approach. Using this approach, the Commissioner's expert arrived at a discount for lack of marketability of 15% on the basis of a study which found that the private placement of unregistered shares has an average discount of about 14.09% higher than the average discount on registered placements.[2] This expert also based his discount on the low risk of the partnership's portfolio.

The court did not find either expert's assumptions and analyses very helpful and therefore used their own analysis and judgment. In McCord v. Commissioner, 120 T.C. at 394-395, the court focused on the Bajaj study and found that a 20% marketability discount was appropriate for interests in a family limited partnership classified as an investment company. In Lappo v. Commissioner, T.C. Memo. 2003-358, the court found that a 21% discount was appropriate for an interest in a family limited partnership consisting of marketable securities and real estate subject to a long-term lease. The court then made a 3% upward adjustment to account for the characteristics specific to the partnership.

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[1] McCord v. Commissioner, 120 T.C. 358, 384 (2003) (quoting Estate of Heck v. Commissioner, T.C. Memo. 2002-34); See also Lappo v. Commissioner, T.C. Memo. 2003-258.
[2] "Firm Value and Marketability Discounts," Dr. Makesh Bajaj, 27 J. Corp. L. 89 (2001)

Since the characteristics of KLLP are similar to the characteristics of the partnership in Lappo v. Commissioner, the court also made a 3% upward adjustment from the 20% discount determined by the Bajaj study. Therefore the court applied a discount for lack of marketability of 23% to KLLP. Additional discounts were not applied for the additional layer of ownership to the value of KLBP LLC.

T&M COMMENTARY

1. This case is remarkable in that the Court allowed a 32% combined discount for an investment company holding only cash and CDs. The IRS position was 25.2% and the Estate position was 53.5%. Many valuation practitioners would have estimated something closer to the IRS position.
2. Why did this case come to trial? There were no evident Section 2036 attacks and the sole issue was the magnitude of the discounts. Obviously, the Estate crossed a reasonable discount line with the IRS.
3. The Court also stated that in determining a marketability discount that there are fundamental differences between operating companies used in the Restricted Stock studies and asset or investment holding companies holding only liquid securities.
4. The Court also faulted both valuation experts on the applicability of some their market data and/or the lack of analysis of their market data. The Court based its conclusion on the discounts in the McCord and Lappo cases. Generally, the Court has rejected appraiser's estimates of discounts based on prior cases.

TUCKER & MELTZER – VALUATION ADVISORS is a business valuation firm focused on the needs of family limited partnerships and closely-held companies. The firm's founding partners have extensive experience and credentials in valuing closely-held and asset holding companies. We have performed over 300 valuations for companies in a large number of industries, reflecting our broad experience in accounting, finance, litigation services, valuation theory and capital transactions.

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