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Understanding Tiered Discounts

By Will Frazier, ASA

Tiered discounts in valuations performed for estate and gift tax purposes will almost always be met with a challenge by the IRS. While many Tax Court cases on this subject exist, the rationale for why such discounts were allowed or disallowed is inconsistent or lacking altogether. Since almost all valuation controversies with the IRS are settled without a trial, having a firm grasp of the justification and magnitude of tiered discounts taken will improve the taxpayer's odds of gaining a satisfactory result. In this paper, we delve into the reasons such discounts exist and break the tiered discount into a hierarchical structure corresponding to situations in which such discounts are commonly encountered. We also illustrate that there are examples of tiered discounts existing in the marketplace providing strong support for such discounts in comparable situations. Finally, our analysis shows that just because a noncontrolling equity transfer between two tiered entities occurs does not guarantee that a tiered discount is justifiable.

Family estate planning often involves an organizational structure consisting of an entity which holds and manages a source of the wealth and one or more related entities used for holding investment interests in that wealth. Each entity or tier in that structure comes with its own internal organizational structure and risks. As ownership interests are transferred from one entity to the next, valuations reflect the manner in which risks impact discounts taken for lack of control and lack of marketability.

"When valuing a holding or investment company, which receives most of its income from holding debt, securities, or other property, the value of the company's assets will receive the most weight."[1] This is especially true if the assets are not associated with an operating company or other active business such as real estate rentals or timber income. Ordinarily, the appraisal of a noncontrolling equity interest in an investment entity which does not receive a recurring cash flow from its investments will be performed under the asset-based approach.

In the adjusted net asset value method, the market value of the entity's assets minus its long-term debt is called Net Asset Value ("NAV"). The fair market value of a noncontrolling, nonmarketable equity interest is determined by applying discounts for lack of control ("DLOC") and lack of marketability ("DLOM"). In appraisal terminology this interest is often referred to as the "Subject Interest." It does not represent an undivided or partial ownership of the entity's assets. Instead, it is a fractional ownership interest in the entity owning the assets. This indirect value relationship with NAV represents a change in nature from a strict pro-rata share of NAV and necessitates the application of discounts.

The term "tiered discounts" implies the application of more than one set of discounts applied in the valuation of a noncontrolling equity interest in an investment entity whose underlying assets are composed of noncontrolling investments in one or more other asset-holding entities.

[1] See *Estate of Andrews v. Commissioner,* 79 T.C. 938, 944-945 (1982).

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The Theory of Tiered Discounts

To understand the issue of tiered discounts, we have to get back to the basic rationale for the existence of discounts. They exist because, relative to NAV, the ownership of the subject interest is burdened with risks not priced into the NAV. If NAV, however, represents an indirect equity interest in another entity, and if NAV was derived by the application of discounts, would discounts applied in determining fair market value represent a double counting?

The answer depends on an assessment of the risks and the magnitude of discounts taken. Just because two tiers exist does not imply that discounts are appropriate at both levels. A discount is only appropriate if a pricing adjustment is required due to a change in the nature of the ownership, which also represents a change in the level of risk.

In business valuation parlance, a "discount" implies the mathematical difference between two prices for the same asset. The differential is most often described as a percent since the purpose of the discount is to describe the relationship of one value with another. The beginning or base value is multiplied by a discount factor. The result is the discounted value.

The usage of discounts as a financial concept is prevalent throughout the world of commerce. Most often a discount is used to express the decrease in value of an asset caused by an event which changes the nature of the asset. After Christmas, a clothing retailer will lower or discount the selling price of merchandise. Physically, the inventory has not changed, but due to the passage of time, its value has diminished. After a hailstorm, an automobile dealership will often sell damaged vehicles at a discount from the prices offered the day before the storm.

The discount described above is merely a mathematical lowering of an asset's price due to the change of the nature of the asset. In one case, the asset has become obsolete. In the other, the asset was damaged. In neither case, is the discounted asset truly the same as the original asset.

Another example is seen with stocks traded in the public marketplace. The market value of stocks fluctuate from day to day. The value changes based on the market's perception for the outlook for each stock based on information which is updated on a continual basis. Thus, the change in value is not due to a change in the nature of the asset but a change in the value of the asset.

For business valuation purposes relating to asset holding entities, discounts are applied in the valuation of noncontrolling and illiquid equity interests. The discounts are applied because of the change in nature of the ownership interest-not because of a change in nature or value of the asset. That is, the base value attaches to an asset. The discounted value is of an equity interest representing an indirect interest in the asset.

Tiered Discounting Process

Here, we introduce the term "source asset holding entity." Since the topic of tiered discounts is a process of related investments, there must be a beginning and an endpoint. The process begins with a source of value held in an entity. This we describe as the source asset holding entity.

Like a river that flows downstream from its source, the tiered discount begins with a valuable asset that is the source of wealth for one or more chained or "tiered" investment entities. The valuable asset can be an operating asset such as a for-profit corporation or income producing real estate. It might also be an intangible asset such as a stock portfolio, royalty interest or even art.

Each business entity, regardless of whether it is an operating or a holding entity and regardless of the legal form (corporation, limited partnership, LLC, etc.), contains two levels of ownership[2]. We will use the term "enterprise level" to describe the asset holding level and "shareholder level" to describe the level holding fractional equity interests of the entity.[3]

If the source asset value is the beginning of the tiered discounting process, the end is found at the fractional equity interest which is the subject of the valuation exercise. This is the interest which has been transferred for gift or estate tax purposes and for which the fair market value must be determined. In the tiered discounting construct this must involve two separate entities but could also encompass a tiered structure which flows through several entities.

There can be only one source asset holding entity. The asset values of any additional tiered entities will always be a derivative of the source entity enterprise level. Thus, for additional entities in the tiered structure, the enterprise level will be described as holding an "Investment asset." The FMV of the shareholder level of that entity would be found by applying any applicable discounts to the investment asset value or NAV of the entity. A description of discounts for lack of control and lack of marketability follows.

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[2] Here we are following the nomenclature of Mercer and Harms in their textbook The Integrated Theory of Business Valuation (3rd edition).

[3] To avoid confusion, we use the term "levels" to describe the two intracompany compartments. "Tiers" is used to describe intercompany differences.

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Discount for Lack of Control ("DLOC")

Also referred to as the "minority interest discount," DLOC is described in all valuation textbooks, so we will not rehash its basics. However, we will discuss how DLOC affects tiered discounting.

Asset risk and governance are the two primary forces which determine DLOC. It follows that a noncontrolling equity interest in a risky and volatile operating business will require a higher discount than a similar interest in an asset holding entity invested in marketable securities. In most businesses involving risk, management is crucial to value. In these situations, the lack of managerial control is all the more important to value. Contrarily, lack of control is relatively less important in an entity holding a portfolio of low-risk assets.

In a tiered discounting situation, the noncontrolling interest held in the asset tier will be accorded an appropriate discount based on both the valuable asset's riskiness and the importance of managerial control. At the investment holding level, the valuation of a noncontrolling interest must account for the fact that the above-mentioned factors have already been priced.

This point was illustrated in *Nelson v. Commissioner* as the tax court allowed a 15% discount for lack of control at the tier involving the operating business which was the source of wealth for the family's limited partnership.[4] When a noncontrolling interest in the FLP was valued, the taxpayer's expert proffered a DLOC of 15%. The court, echoing the sentiment of the IRS' appraisal expert that the possibility of a lack of control disadvantage was remote, allowed a discount of just 5%.

One might observe that the FLP held interests in an operating company, not marketable securities. However, it must be recognized that the riskiness of the operating company was taken into account in determining the DLOC and DLOM applicable to the FLP's holding in the company. Thus, in Nelson, the court allowed only a token amount to second tier DLOC discount.

Governance and the Tiered Discount

This is a broad topic, but its various facets seem to give rise to most of the justification for the tiered discounting process. While often seen as a factor influencing the lack of control discount, as we shall describe, a change in governance usually affects marketability as well. As has been noted in a number of U.S. Tax Court cases, there is considerable overlap between DLOC and DLOM and "unscrambling the eggs" is a difficult process.[5]

Following are governance characteristics that change in the transfer of the subject interest.

Asymmetrical Information

Asymmetrical information can be defined as information that is known to some people but not to other people. This economic concept was made famous by Nobel Prize winning economist George Akerlof in his article, "The Market for Lemons." The classical argument is that some sellers with inside information about the quality of an asset will be unwilling to accept the terms offered by a less informed buyer. Conversely, buyers are wary of paying for an asset about which they are not fully informed. This is also referred to as "adverse selection."

Buyers of investment interests from other holders in private equity funds or real estate limited partnerships usually receive far less information about the investment than did the original investors. For example, in the original investment process the buyers are provided with a private placement memorandum and direct contact with management.
An important additional informational concern has to do with the inability of the buyer of the secondary interest to have much understanding about the manner by which NAV is determined. This is especially more problematic for older investments that have underperformed. Even for investment platforms that have performed well in the early years, the concern is that the investments remaining in the private equity fund or real estate partnership may be the ones that will be more difficult to exit profitably in the future. These are also the assets which are difficult to value for NAV purposes.

Management

This element of concern can arise in the valuation of the fractional interest in the entity holding investment assets which have been discounted in the determination of NAV. For example, in valuing the fractional interest in an investment holding entity, we note that its management is usually not the same as the management for the source asset holding entity - the entity with operational control of the valuable asset. A frequently encountered issue here is whether or not distributions made will be passed through to the noncontrolling equity investors of the investment holding entity (the subject interest).

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[4] *Nelson v. Commissioner*, T.C. Memo 2020-81.

[5] See *Estate of Andrews v. Commissioner*, 79 T.C. 938, 953 (1982) and *Estate of Richie C. Heck v. Commissioner*, T.C. Memo. 1999 (37-42).

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Organizational Structure

Differences in the rights and expectations of investment holders can exist between the entity owning the valuable asset and the entity which holds a fractional interest in that entity. For example, the entity owning the source-of-value asset might be a general partnership or corporation. The entity holding the fractional interests might be a different type of entity such as a limited partnership or limited liability company. The fractional (and noncontrolling) owner will have fewer rights and protections than does the investment entity as a whole.

DLOC as a risk factor usually diminishes significantly with each successive tier encountered. It will be an unspecified, but majority, portion of a combined discount taken from the secondary marketplace when determining the FMV of the source asset holding entity's shareholder level interests. Most often, the risk profile of these equity interests is relatively high. In the DLOC taken at the next (investment) tier, the risk-mitigated asset will be associated with a market example of lower risk, such as a discount taken from the closed-end fund market (CEF). The resulting now twice risk-mitigated asset would carry a very low risk profile asset such as a government or AAA-rated bond or it might be considered entirely risk free.

Figure 1

Transformation of Asset Risk in Tiered Discounting DLOC
Transfer of Noncontrolling Interests

Transferor (1)		Transferee (2)	Risk Characterization		Risk Characterization
Source Asset Holding Entity Shareholder Pro-Rata NAV	→	Investment Holding Entity - Enterprise Level	Pre-Transfer	High	Real Estate Private Equity
			Post-Transfer	Low-Moderate	Large Cap REIT
Investment Holding Entity - Enterprise Level	→	Investment Holding Entity - Shareholder Level	Pre-Transfer	Low-Moderate	Large Cap REIT
			Post-Transfer	Low	AAA Bond

(1) Proxy for hypothetical willing seller.
(2) Proxy for hypothetical willing buyer.

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Discount for Lack of Marketability (“DLOM”)

As is the case for DLOC, a general description and understanding of DLOM in valuing noncontrolling interests can be gained from virtually every business valuation textbook published.

In a tiered discounting setting, DLOM operates somewhat differently than does DLOC. At each successive discounting point, DLOC is primarily calculated as a decreasing function of the original DLOC. To the extent that asset risk impacts DLOM, that risk will mirror the decreasing impact seen in DLOC. But at each tier, DLOM is also impacted by the particular equity interest being considered and the avenues available for re-selling that interest.

At the first tiered discount encountered in our example, DLOM was considered to be either a part of the combined discount or an additional component added to the combined discount. Thus, either that interest could be sold in the secondary marketplace or, if not, its close association with the source asset value would make the prospects of a private placement highly likely. For example, there is no secondary market for noncontrolling interests in operating companies, but there is a very active private placement market for such interests.

For the investment entity level DLOM, the process of finding a willing buyer of the noncontrolling interest would be far more difficult, lengthy and costly. However, it must be recognized that the investment holding entity NAV has already been reduced for similar costs. Accordingly, DLOM should represent only the marginal costs of illiquidity encountered only at the investment level.

The subject of tiered discounts can become complex and highly nuanced based upon a number of factors, such as:

1. Type and characteristic of the source asset

- a. Direct
    - i. Real (e.g. income-producing real estate, timber)
    - ii. Investment asset (e.g., marketable securities, gold, crypto currency, etc.)
- b. Indirect
    - i. Equity interests in entities holding other valuable assets
        1. Operating businesses
        2. Real estate limited partnerships
        3. Oil and gas production
    - ii. Royalties, copyrights, etc.

2. Type and characteristic of the source or investment asset ownership

- a. Direct
- b. Indirect
    - i. Partially controlling
        1. General partnership or joint venture
        2. Significant voting interest in corporation or partnership
    - ii. Noncontrolling equity interest

3. Governance

- a. Management
    - i. Direct, active management of the source assets
    - ii. Indirect or passive role
    - iii. Ability to be replaced
    - iv. Commonality between tiered entities
- b. Terms
    - i. Restrictive covenants
    - ii. Liquidation
- c. Contractual
    - i. Buy-sell agreement
    - ii. Right of first refusal
    - iii. Puts or calls

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The Type 1 Tiered Discount

We use the term “type 1 tiered discount” to exemplify a discount taken for which there is (1) direct, comparable market evidence for the valuation discount taken to determine the FMV of the source asset entity’s shareholder level FMV and (2) a fractional, noncontrolling share of the source asset holding entity’s equity is held by a separate investment entity and there is a transfer of a fractional, noncontrolling interest in that investment entity for which FMV must be determined. In the type 1 tiered discount construct there are only two entities involved — the source asset holding entity and an investment entity holding a fractional interest in the equity of the source asset holding entity.

Most often, to satisfy the first part of the definition, the valuation discounts applicable to the source asset holding entity’s equity will be derived from the secondary marketplace or active private placement marketplace such as that for noncontrolling interests in operating companies. For operating entities in various sectors such as private equity, real estate and oil and gas, secondary markets exist wherein fractional interests are bought and sold on a regular basis. The pricing information of such transactions is discoverable and may be used for valuation purposes. As these interests are held in non-publicly reporting entities, the data is limited. Most often, the pricing information containing valuation metrics is also limited but for private equity and real estate investments a combined discount from NAV may be observed.[6]

The application of discounts implies that the nature of the specific equity interest has changed in the transfer from one holder to the next. At the first step, when the FMV in the equity interest in source asset holding entity is determined, the nature of the interest changes from being considered a pro-rata integral part of the enterprise to a fractional interest separated from the controlling envelope of that enterprise. At the second step, it is almost universal that the managers of the source asset holding entity and the investment entity are not related.

Illustration of a Type 1 Tiered Discount

For purposes of our discussion, let’s assume ABC Real Estate Development, L.P. (“ABC”) directly owns and operates an income producing shopping center – Southpark Shopping Center. The limited partners were the original investors in the development.

Figure 2

ABC Real Estate Development, L.P.							
Enterprise Level Owns Operating Assets	GP 1%	LP1 16.5%	LP2 16.5%	LP3 16.5%	LP4 16.5%	LP5 16.5%	LP6 16.5%
Shareholder Level Fractional Equity Interests	Operating Control	Noncontrolling	Noncontrolling	Noncontrolling	Noncontrolling	Noncontrolling	Noncontrolling

At this first step in the tiered discounting process, Southpark Shopping Center exists within the ABC enterprise level, and indirectly, at the ABC shareholder level. That is, the titled ownership of the real estate is held by the limited partnership entity. At the shareholder level, the limited partners don’t own any interest in the real estate. They own fractional equity interests in ABC. On an aggregate basis, the general and limited partnership interests control ABC, and therefore, the real estate. Individually, however, the limited partners have a very minor voice in the management of ABC’s business.

The ABC limited partners were the original investors and invested on an undiscounted, pro-rata basis. The objective of the investment was to achieve its primary return upon the sale of the investment — the proceeds of which they would share on a pro-rata basis. Further, prior to the sale and exit of the investment, any distributions would be made to these investors on a pro-rata basis. In many cases, these interim distributions are quite substantial and occur over many years. Thus, without any other reason, the NAV of the ABC limited partnership interests would ordinarily be thought of as being a pro-rata share of the NAV of the ABC enterprise. But this is a “fair value” or “investment value” concept — not fair market value.

The fair market value of fractional limited partnership interests in ABC is based on what a third party, hypothetical investor would pay for it. In this instance, since this is the type of investment interest which trades in the secondary marketplace, we would look to that market to determine FMV. Invariably, FMV will be found at a price that represents a discount to a pro-rata share of the ABC NAV.

The discounts taken here are not tiered discounts, they are just ordinary discounts. The concept of a tiered discount doesn’t come into being until there are two sets of discounts with related assets, and at times, related management. In most instances, a tiered discount will involve equity interests in two separate entities with interrelated NAVs.

[6] In these secondary markets, the transaction price per unit can be compared with the NAV per unit. This almost always represents a discounted price. The discount is termed “combined” because no direct information is provided as to how much is related to lack of control or lack of marketability.

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A frequently-occurring tiered discount scenario arises when the ABC limited partner is an entity and not an individual. Let's say, in this case, the Smith Family, L.P. ("Smith, LP") is one of the six limited partners of ABC, and holds a 16.5% LP interest in ABC. Smith, LP is held by the three branches of the Smith family represented by the siblings, John, William and Elizabeth Smith.

Here, we will use the simplifying assumption that Smith LP holds no other assets than the fractional interest in ABC. For this reason, its NAV is the same as the FMV of the ABC limited partnership interests to which discounts have already been applied. In effect, the ABC shareholder level value (FMV) becomes the Smith, LP NAV (enterprise level).

When a noncontrolling interest in Smith, LP is transferred, it, too, will be valued at a discount from NAV. This constitutes a tiered discount as we now have a transfer of an illiquid, non-controlling interest in an entity whose NAV is based upon a discounted NAV of a separate but related entity.

Our tiered discounting construct follows a sequential order that begins with the ABC enterprise level and flows down to the 30% interest held by John and Mary Smith in Smith LP. Thus, the valuable asset is held at the ABC enterprise level. A noncontrolling equity interest in the ABC shareholder level is owned by a separate investment entity — Smith, LP. Finally, we determine the FMV of John and Mary Smith's 30% limited partnership interest in Smith, LP.

As already mentioned, the discounted NAV of ABC becomes the NAV of Smith, LP. But this not a mere mathematical transference from ABC to Smith, LP. The risk nature of the asset held by Smith, LP is different than that held by ABC. In determining FMV, the discounting that occurred between the ABC enterprise and shareholder levels was for the purpose of recognizing the lack of control and lack of marketability that exists for the fractional interest relative to the enterprise level. Once valued on this basis, the risk nature of the ABC limited partnership interest (ABC shareholder value/ Smith, LP enterprise level) has been transformed to a much lower level.

The discounting for the Smith, LP shareholder level tier is derived from market studies of transactions deemed to be comparable to the risk profile of the Smith, LP shareholder level fractional interest. A noticeable difference between the discounting at the source asset holding entity and investment entity is that the source asset discount comes directly from a secondary market in which the same type of interest is traded. For the investment entity, the discounts are inferred indirectly from markets for securities which are "generally similar" to the subject interest.

In Figure 3 of this paper, the discounts selected are purely illustrative. The combined discount chosen for the ABC shareholder/Smith, LP enterprise levels is primarily due to the lack of control of the investment since there exists a market for the purchase and sale of such interests. Usually, these markets are much thinner and more inefficient than the U.S. public market for stocks and bonds. For this reason, some element of lack of marketability is added. There may also be some unique characteristics of the subject interest (especially in its governance) which create the need for an enhanced lack of marketability discount.

The discount for lack of control of the Smith, LP shareholder level is with a view that the asset risk found at the ABC enterprise level has been mitigated to a large extent via the previous discounting. Thus, the risk of the investment asset is far lower than the asset risk of the source asset. However, the risk is not zero. One caveat here, however, would be that distributions received at the Smith, LP enterprise level and not passed through to the Smith, LP limited partners would create a lack of control risk factor not present at the ABC shareholder level.

The marketability of the Smith, LP interest held by John and Mary Smith is far lower than the limited marketability of the ABC limited partnership interests. In fact, the Smith, LP limited partnership interests are nonmarketable. Finding a buyer would involve an expensive and lengthy private placement process.

A variant of the type 1 discount is what we would call the "type 1.A. tiered discount," The facts are the same as above except the source asset is not from an operating entity or risky asset. The source-of-value asset is of low risk such as a diversified portfolio of marketable securities. That being the case, the initial discount in determining the source asset holding company shareholder level FMV/ investment entity NAV would not be a combined discount but would follow the traditional method of discounting for both lack of control and lack of marketability. Whether or not discounts might be taken in determining the FMV of an interest at the investment entity shareholder level will be based on facts and circumstances. An important issue here would be commonality (or lack thereof) of the management of the source asset and investment asset holding entities. Also very important will be the difference in the governance of the two entities. A third factor could be the interrelatedness of the fractional interest holders of the two entities.

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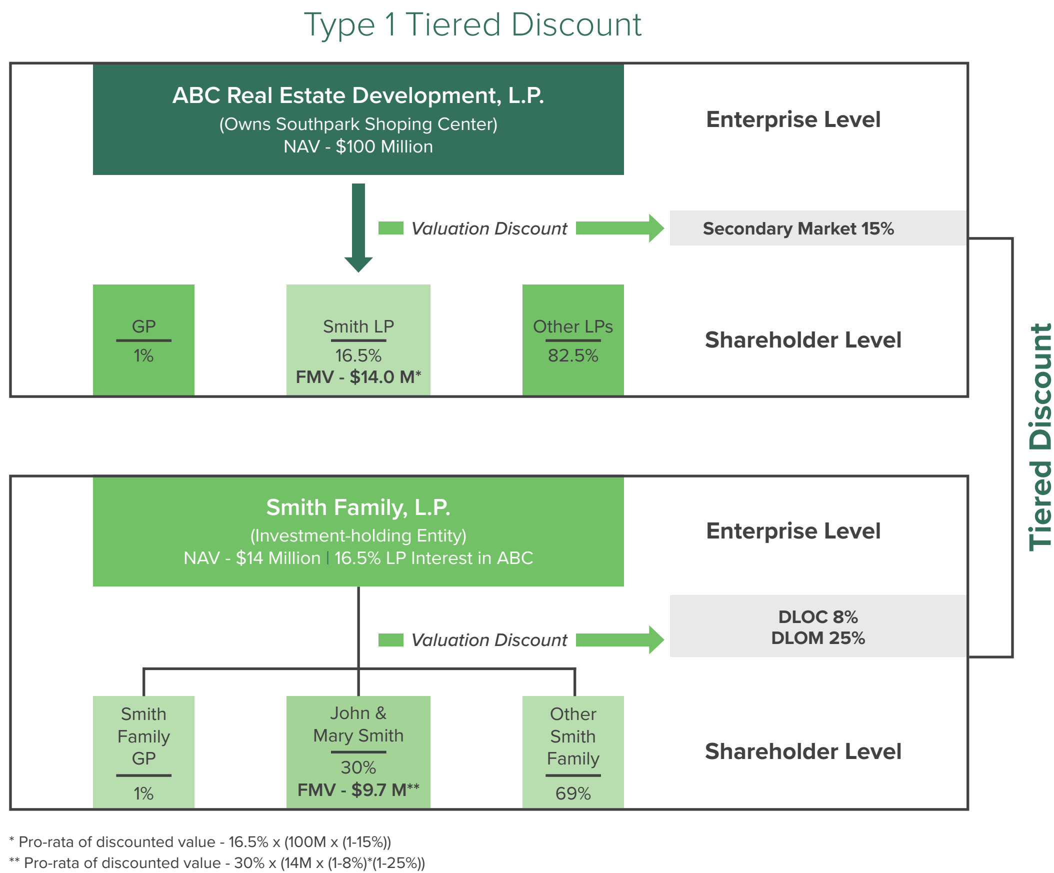
Figure 3



* Pro-rata of discounted value - 16.5% x (100M x (1-15%))

** Pro-rata of discounted value - 30% x (14M x (1-8%)*(1-25%))

Type 2 Tiered Discounts

In the type 1 tiered discount only two entities are involved in the discounting process. In the type 2 tiered discount, three entities are involved.

Type 2 tiered discounts exist when a fractional interest in an investment (non-value source) entity is held by another investment entity and a fractional, noncontrolling interest in that second investment entity is transferred to another party requiring a valuation and the consideration of whether or not additional discounts are warranted. In this structure, the NAV of the first investment entity is at a risk-mitigated value relative to the source asset holding enterprise level NAV. The NAV of the second investment entity is found by risk-reducing whatever lack of control and lack of marketability risk exists at the FMV of the first investment entity's shareholder level interest.

There often is an overlap in the management and equity owners between the two investment entities. Frequently, the management and other equity holders are of the same family. At this level, the functions of management may be very limited, and as such, any risk due to lack of control would be slight. Further, any lack of marketability discount would only represent any marginal or additional risk not already captured at the source asset or first investment entity levels. Likely, any marginal discounts found at the shareholder level of the third tier entity would be related to differences in the governance of the entities.

There are no secondary markets for equity interests for which a type 2 tiered discount might be applied. Accordingly, discounts must be applied based upon reason and logic which will be dictated by the facts and circumstances of each situation.

Illustration of a Type 2 Tiered Discount

Let's assume John and Mary Smith wish to transfer their nonmarketable, noncontrolling interest in Smith LP to their own family entity, JAS Partners, LP. This will be followed by a gift of four separate limited partnership interests to trusts set up for their four children-Charles, Robert, Susan and Ann.

The FMV of John and Mary's 30% limited partnership interest in Smith, LP becomes the NAV of JAS Partners, LP. The four separate 20% gifted interests will ordinarily be discounted for lack of control and lack of marketability in the determination of FMV.

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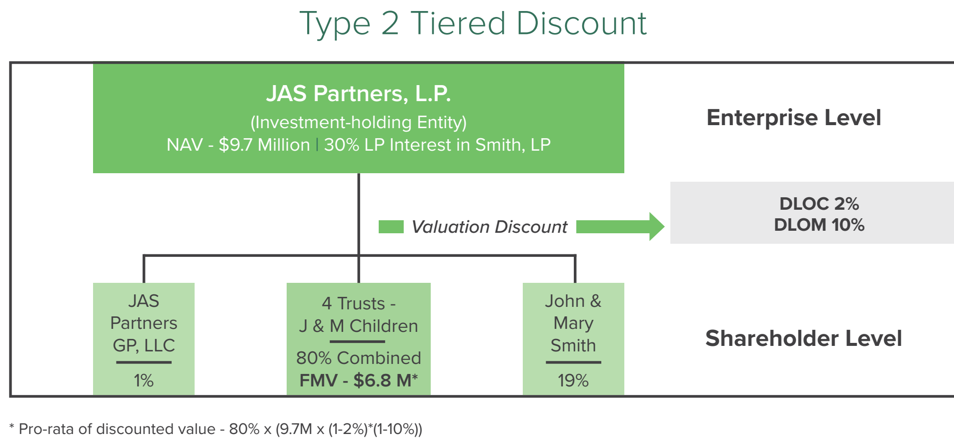
Figure 4



* Pro-rata of discounted value - 80% x (9.7M x (1-2%)*(1-10%))

Finally, in the valuation of the four separate interests gifted to the children's trusts, discounts for lack of control (2%) and lack of marketability (10%) were selected. For DLOC, a CEF holding nearly risk free assets was selected. For, DLOM, the discount was determine based upon a rational argument but no empirical benchmark evidence was available.

Market Evidence of Tiered Discounts

Evidence of tiered discounting exists in the marketplace. The pricing of stocks of closed-end funds represents a form of tiered discounting. The publicly-traded stocks held by the CEF are themselves minority interests that trade at substantial discounts from the value of issuing company as a whole. The market prices of CEFs trade at a discount from each fund's NAV, which is based upon minority interest pricing.

In private equity, one large investment fund class is "fund of funds." These funds invest as noncontrolling investors in other funds that acquire controlling interests in the equity of other companies or partnerships. Investors in a fund of funds themselves acquire illiquid and noncontrolling interests. Some of these investors may resell their investments in the private equity secondary marketplace at a discounted price.

The tiered discounts evidenced from the pricing of publicly available information for the situations described above is ultimately caused by an increase in risk for the new owner of the subject interest relative to the position of the seller. To justify the decrease in price (which gives rise to the discount), some new element of risk must be encountered that was not present with the subject interest in its pre-sale condition.

These marginal risks are almost always associated with a change in the governance of the subject interest. The change in governance may increase the holder's investment risk due to a weakening of control, or a decrease in information or the reliability of information. These factors might be evidence of an increase in lack of control, but because of the general unattractiveness of these facts, these factors also magnify the lack of marketability of the subject interest.[7]

Since the tiered discount is a manifestation of marginal or additional risk, it necessarily follows that a basic or core discount will exist. The core discounts for lack of control and lack of marketability are found at the partnership level. These are the typical discounts attendant to fractional ownership in an investment entity. Discounts taken at the asset level should only be related with respect to the nature of the asset holding. The control or liquidity of the investment tier should not influence the discount taken at the asset level.

Tiered Discounts in the U.S. Tax Court

Evidence of tiered discounts can be found by reviewing U.S. Tax Court cases. The support for opinions in every case is different and, so, valuation conclusions found therein should not be used directly in the valuation of any subject interest. However, such cases can be very useful in illustrating factual matters that influenced valuation determinations such as discounts. The examples we provide are but a few of many such examples found in reported Tax Court cases.

In *Astleford v. Commmisioner*, the Astleford Family Limited Partnership ("AFLP") owned real estate and a 50% general partnership in Pine Bend Development Co. ("Pine Bend"), which also owned real estate.[8] The other 50% GP interest in Pine Bend was held by an unrelated third party. In valuing the GP interest held by AFLP, the Tax Court determined a combined discount of 30%. Thus, AFLP's NAV was composed of directly owned real estate and a discounted fractional ownership in Pine Bend. The Court also determined discounts from NAV of 17.47% for lack of control and 22% for lack of marketability for the AFLP limited partnership interests.

[7] To the investment community, there is almost never a discussion as to whether the observed discounts from NAV are for "lack of control" or "lack of marketability". For this reason, in many cases an appraiser's use of a combined discount may make the most sense.
[8] *Astleford v. Commissioner*, T.C. Memo. 2008-128.

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The tiered discount evidenced for AFLP's 50% Pine Bend GP interest is of the type 1 tiered discount described above. In our opinion, the most important elements were that the other holder of the 50% Pine Bend GP interest was an unrelated third party and the nature of the interest changed from an equity interest with half control of the asset to a limited partnership interest with little or no influence. *Gow v. Commissioner* are other examples of a type 1 tiered discount.[9]

In *Nelson* (footnote 4), the Nelson family controlled Warren Equipment Co. ("WEC") a large construction equipment dealer that also owned several other operating businesses. The overwhelming majority of WEC's stock was held by Longspar, Ltd., the Nelson family limited partnership. In determining the NAV of WEC the Court allowed discounts for both lack of control (15%) and lack of marketability (30%). In the determination of the fair market value of noncontrolling and nonmarketable interests in Longspar, the Court arrived at discounts lack of control of 5% and lack of marketability of 28%. *Nelson* is also an example of a type 1 tiered discount.

Martin v. Commissioner is an example of a tiered structure for which discounts were disallowed by the Tax Court.[10] The Court stated: "Thus, insofar as the gifted Arbor shares represent an interest in the seven Martin family corporations, lack of control over the family corporations and the lack of marketability of the shares of such corporations is more appropriately addressed at the level of the underlying corporations." In the 1985 gift tax opinion in Martin, Arbor, Inc. was described as a closely held personal holding company. Arbor owned 4,000 acres of timberland directly and minority investment interests in seven Martin family-held corporations. There was some cross-ownership of shares among the family-held corporations (for example, Martin Timber Company owned a minority interest in Martin Home Centers, Inc., etc.).

Tiered Structures without Separate Discounts

As cited previously, just because a tiered structure exists does not mean a valuation discount is justifiable. Discounts must evidence an increase in investment risk from one level to the next. In many industries, especially in real estate, a series of controlled entities may intervene between the entity directly owning the income producing or valuable real estate and the investment entity owning the subject interest. The intervening entities may exist for tax, legal or organizational purposes, but unless the intervening entity magnifies the risk of the subject interest holder then, for valuation purposes it has no effect.

The Global Discount

At the end of the day, the purpose of the process we have been describing is to determine the fair market value of a particular subject interest. We should remind ourselves that the incremental discounting used above is not mandatory. It is found in a few court cases and business valuation articles. Overall, the methodology is largely untouched by valuation textbooks.

Another way to go about the discounting process is to take the perspective of the holder of the subject interest and, simultaneously at all levels, consider the factors we have discussed regarding asset risk, governance, management and liquidity. Fair market value is determined by the application of a single DLOC and DLOM.

In Figure 4, the combined total discounts embodied in the fair market value of the 20% interests in JAS Partners, LP is 48.3%. This same amount of discounting might have been achieved by assessing one DLOC of 20% and one DLOM of 35%. A hybrid approach would be to take the relatively unassailable 15% combined discount found at the shareholder level of the asset entity and then apply one DLOC of 12.5% and one DLOM of 30%.

For the more straight forward (type 1) tiered structure we have depicted in Figures 1-3, it is doubtful that the global discounting process would be as convincing. However, as additional tiers intervene between the source asset and the subject interest, the ability to objectively determine discount factors at each step becomes problematic. The global approach may be superior in this type of setting.

[9] *Gow v. Commissioner*, T.C. Memo 2000-93 (Mar. 20, 2000), aff'd 19 Fed.Appx. 90 (4th Cir. 2001).
[10] *Roy O. Martin, Jr., and Barbara M. Martin v. Commissioner*, T.C. Memo 1985-424 (Aug. 14,1985).

KEY CONTACT:

WILL FRAZIER, ASA
MANAGING DIRECTOR, VALUATION SERVICES
O: 832.320.7930
WILL.FRAZIER@WEAVER.COM

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