Multi-Level Discounts for Tiered Entities and
Lack of Marketability Discounts for Wholly Owned Entities

Mannes F. Greenberg Wednesday Tax Study Group

Walter R. Stone
Adelberg, Rudow, Dorf & Hendler, LLC

February 4, 2015

I. Introductory Comments

Citing Treas. Reg. §20-2031-1(b), the United States Supreme Court in *United States v. Cartwright*, 411 U.S. 546, 551 (1973) stated that fair market value ("FMV") has been defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Each case is driven by the specific facts of that case and therefore it may be difficult to rely on the outcome of any one case in its application to another set of facts. However, it appears that the United States Tax Court (the "Tax Court") has enumerated certain principles in cases pertaining to multiple discounts for tiered entities that will be reviewed in this presentation.

The Tax Court has also been faced with a number of cases dealing with the question of whether lack of marketability discounts are available when valuing the interest in a closely held business wholly owned by one person. Marketability has been defined as "the ability to convert an investment into cash quickly at a known price and with minimal transaction costs"[1]. The lack of marketability discount indicates the decrease in the value of an investment to reflect a reduced level of marketability. Such a decrease may be due to a number of factors, including restrictions on the transfer of the investment and the absence of an active market after taking into consideration the time, effort and expense to be incurred in the sale of the investment.

The principles enunciated by the Tax Court in its determination of whether an interest which is held by a single owner may be subject to a discount for lack of marketability are also discussed in this presentation.

Unless otherwise noted in this presentation, it has been assumed that each applicable entity has been formed for valid business or estate planning purposes.

[1] Glazer, *Understanding the Valuation Discount for Lack of Marketability*. The CPA Journal Online, August 2, 2005.

II. Multi-Level Discounts for Tiered Entities

A. Federal Tax Decisions in favor of Multi-Level Discounts

1. *Whittemore v. Fitzpatrick*, 127 F.Supp. 710 (D. Conn. 1954)

(a) Facts. Harrris Whittemore ("Mr. W"), the sole shareholder of J.H. Whittemore Company ("W Co."), gifted 600 shares of W Co. stock to a trust designating a gift of 200 shares for the benefit of each of his three sons. In addition to other assets valued at approximately $11,825,000, W Co. owned 18,366 common shares (a non-controlling interest) in the common stock of Peter Paul, Inc. ("PP Inc."). PP Inc. stock was traded over-the-counter. Mr. W valued each gift of 200 shares of W Co. (in each instance representing 24.4% of the outstanding shares of W Co.) at $1,000 per share and the Internal Revenue Service (the "Service") valued the stock at $3,228 per share.

(b) District Court's Decision. The District Court allowed discounts at both the lower tier and upper tier levels, holding that the FMV of the shares held by W Co. in PP Inc. reflected a blockage discount of approximately 11.8%. The District Court held that it was appropriate to value each gift of 200 shares of W Co. and not 600 shares as an entirety since 200 shares were gifted in trust separately for the benefit of each son. The District Court then applied a combined discount for lack of control and lack of marketability of 66.1% based on an average of the discounts applied by each of the taxpayer's three experts resulting in a value of $1,057 per share for each gift of 200 shares.

2. *Dean v. Commissioner*, T.C. Memo. 1960-54

(a) Facts. Taxpayers gifted 2,000 shares (a 5.5% interest) in the common stock of Nemours Corporation ("Nemours") to separate trusts for the benefit of their children. The FMV of the gifted shares was reported on the gift tax return at $425 a share. The Service valued the stock in Nemours at $884 a share. Nemours was a personal holding company with its principal asset being 33,000 common shares (or 4.24%) of the outstanding shares of Delaware Realty and Investment Company ("Delaware Co."), a closely held corporation. In addition, Nemours conducted farming operations on 14,000 acres in Alabama and Delaware. The principal assets of Delaware Co. consisted of non-controlling interests in the stock of publicly held corporations, including a non-controlling interest in the common stock of Christiana Securities Company ("Christiana"), a publicly traded holding company whose principal assets were in turn non-controlling interests in the stock of publicly traded corporations.

(b) Tax Court's Decision. The Tax Court accepted valuation discounts at both the upper tier and lower tier levels. The Tax Court allowed a 14% discount for the stock interest of Nemours in Delaware Co., and a discount of 20% for the stock interest in Nemours gifted by the taxpayers. The discounts for the interests in each entity were based on the nature of the entity, its earnings, dividend-paying capacity, net worth and other relevant factors.

3. *Gallun v. Commissioner*, T.C. Memo. 1974-284

(a) Facts. A.F. Gallun & Sons Corporation ("Gallun"), a closely held company, operated a leather tanning operation and also owned a significant investment portfolio of stocks and bonds (which had an aggregate quoted market value of $18,087,263 and which constituted the bulk of Gallun's value). The taxpayer, the largest company shareholder with a 28.7% ownership interest, gifted 400 shares of Gallun common stock (approximately 2.5%) to family members. Taxpayer reported the fair market value of the gifted shares at $396.24 per share. The Service determined the fair market value of the stock to be $661.37 per share.

(b) Tax Court's Decision. The Tax Court held that the fair market value of the gifted stock was $520 a share. The Tax Court accepted the methodology applied by the expert for the Service at the lower tier entity level, resulting in a discount of 10.4% at the lower tier level to reflect blockage and the estimated expenses of underwriting a registered secondary public offering associated with the two large blocks of stock owned by Gallun, and then applied a discount of 55% at the upper tier level to reflect combined discounts for lack of control and lack of marketability[2].

4. *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979)

(a) Facts. The taxpayer owned non-controlling interests in Piper Investment Co., Inc. ("Piper Investment") and Castanea Realty Co., Inc. ("Castanea"). The taxpayer made gifts of all of the shares of Piper Investment and Castanea owned by the taxpayer. Piper Investment and Castanea were holding companies that owned nonregistered shares of Piper Aircraft Corp. ("PAC"), real estate and cash. Piper Investment, Castanea, the taxpayer and members of the taxpayer's family owned a substantial block of PAC's stock. Piper Investment owned 37,500 shares of PAC and Castanea owned 67,500 shares of PAC. PAC was listed on the New York Stock Exchange. However, the 105,000 shares of common stock in PAC owned by Piper Investment and Castanea were not registered with the Securities and Exchange Commission. The majority of Piper Investment's and Castanea's assets on a book value basis were the investments in PAC common stock and real estate.

---

[2] In *Gallun*, the Tax Court specifically rejected any discount for built-in capital gains tax as the record did "not establish that the management of the portfolio had any immediate plans to liquidate the investment portfolio" and that certain or all investment assets may have been disposed of without the imposition of a capital gains tax. Recent cases have allowed a discount for built-in gains taxes on a dollar-for-dollar basis regardless of the likelihood of liquidation. See *e.g.*, *Estate of Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002), revg. T.C. Memo. 2000-12; *Estate of Jelke v. Commissioner*, 507 F.3d 1317 (11th Cir. 2007), vacating T.C. Memo. 2005-131; *Estate of Jensen v. Commissioner*, T.C. Memo. 2010-182.

(b) Tax Court's Decision. The Tax Court accepted the value for the PAC common stock at the lower tier level determined by the Service's experts, based on a discount of 12% to reflect the costs of registering and selling the PAC common stock[3].

At the upper tier level, the Tax Court allowed (i) a 17% portfolio discount due to the undiversified nature of the assets owned by Piper Investment and Castanea, and (ii) a 35% discount for lack of marketability. In *Piper*, even the experts for the Service concluded that it was appropriate to apply discounts at both the lower and upper tiers.

5. *Kosman v. Commissioner*, T.C. Memo. 1996-112

(a) Facts. The taxpayer gifted non-controlling shares of the voting common stock and the non-voting common stock of Kosman, Inc. ("KI"). KI was a holding company, which owned (i) 32.085% of Scottsbluff National Company ("SNC") (the owner of 100% of Scottsbluff National Bank), and (ii) 2,000 shares (10%) of Western National Bank.

(b) Tax Court's Decision. The Tax Court allowed discounts at both the lower tier and upper tier levels. The Service's experts applied a 15% discount for lack of control and a 10% discount for lack of marketability in their valuations of KI's interest in SNC (the lower tier entity). Even though the Tax Court failed to comment on the discounts taken by the Service's experts at the lower tier level, the Tax Court's determined value of KI's interest in SNC at the lower tier level was lower than the value as determined by the Service's experts. The Tax Court also concluded that the FMV for KI's ownership interest in SNC was based upon 70% of SNC's book value. The Tax Court further permitted discounts of 20% for lack of control and 15% for lack of marketability at the lower tier level. In addition, the Tax Court accepted discounts of 10% for lack of control, 15% for lack of marketability and 4% for lack of voting power at the upper tier level (the taxpayer's interest in KI)[4].

6. *Gow v. Commissioner*, T.C. Memo. 2000-93, *affd.* 19 Fed. Appx. 90 (4th Cir.2001)

(a) Facts. In 1989 and 1990, taxpayer, the president and the chairman of the Board of Directors of Williamsburg Vacations, Inc. ("WVI"), received 800 shares and 400 shares, respectively, of the common stock of WVI in accordance with WVI's stock bonus plan. The shares received in each year represented only minority interests in WVI. In both years, WVI was a one-third partner in a joint venture known as Powhatan Associates ("Powhatan") which operated a time-share resort project. Powhatan's joint venture agreement contained certain restrictions on the transferability or the sale of the ownership interests in Powhatan. Taxpayer and the Service disagreed as to the value of the stock granted under the stock bonus plan.

---

[3] The Tax Court rejected the discount for built-in capital gains applied by the taxpayer's expert since there was "no evidence that a liquidation of the investment companies was planned or that it could not be accomplished without incurring a capital gains tax at the corporate level" at 1087. See Footnote 2.

[4] The Service's experts conceded that it was appropriate to apply discounts for both lack of control and lack of marketability at both the lower tier and upper tier levels.

(b) Tax Court's Decision. The Tax Court agreed with the taxpayer's experts regarding a 15% lack of control and a 30% lack of marketability discount as of both relevant dates at the lower tier level. The Tax Court also accepted the taxpayer's expert's opinion regarding the appropriate discounts to apply at the upper tier level: a 20% discount for lack of control and a 30% discount for lack of marketability on the first stock bonus date and a 30% discount for lack of control and a 30% discount for lack of marketability on the second stock bonus date.

7. *Astleford v. Commissioner*, T.C. Memo. 2008-128

(a) Facts. Astleford Family Limited Partnership ("AFLP") was formed by the taxpayer in 1996 and incidental thereto, the taxpayer transferred her ownership interest in an elder-care facility. In 1996, the taxpayer gave each of her three children a 30% limited partnership interest in AFLP, retaining a 10% general partnership interest. In 1997, the taxpayer transferred to AFLP a 50% interest in Pine Bend Development Co. ("Pine Bend") and her ownership interests in 14 other real estate properties, including a large tract of agricultural farmland in Rosemount, Minnesota, resulting in a significant increase in the taxpayer's percentage interest in AFLP. Simultaneously with such transfers in 1997, the taxpayer gave additional limited partnership interests in AFLP to her three children in order to restore each of their ownership interests in AFLP to 30%. Taxpayer argued that a substantial discount should be allowed at the lower tier level for the 50% general partnership interest in Pine Bend to reflect that such an interest was an assignee interest rather than a general partnership interest.

(b) Tax Court's Decision. The Tax Court rejected the taxpayer's assignee interest argument. However, the Tax Court applied a combined discount for lack of control and lack of marketability of 30% at the lower tier level based on an analysis of certain RELP data used by the taxpayer's expert. At the upper tier level, for the gifted limited partnership interests in AFLP, as of the two valuation dates, the Tax Court allowed discounts for lack of control of 16.17% and 17.47%, respectively, and discounts for lack of marketability of 21.23% and 22%, respectively. In *Astleford*, the Tax Court's decision to allow discounts at both the lower tier and the upper tier levels was based on the rationale that the lower tiered interest did not constitute a significant portion of the upper tier company's assets. The Tax Court noted:

> … this Court, as well as respondent, has applied two layers of lack of control and lack of marketability discounts where a taxpayer held a minority interest in an entity that in turn held a minority interest in another entity. See *Estate of Piper v. Commissioner*, 72 T.C. 1062, 1085, 1979 WL 3788 (1979); *Janda v. Commissioner*, T.C. Memo.2001-24; *Gow v. Commissioner*, T.C. Memo.2000-93, affd. 19 Fed. Appx. 90 (4th Cir.2001); *Gallun v. Commissioner*, T.C. Memo.1974-284. However, we also have rejected multiple discounts to tiered entities where the lower level interest constituted a significant portion of the parent entity's assets, see *Martin v. Commissioner*, T.C. Memo, 1985-424 (minority interests in subsidiaries comprised 75 percent of

> parent entity's assets), or where the lower level interest was the parent entity's "principal operating subsidiary", see *Estate of O'Connell v. Commissioner*, T.C. Memo. 1978-191, affd. on this point, revd. on other issues 640 F.2d 249 (9th Cir. 1981). [Emphasis Added].[5]

The Tax Court further noted:

> The 50-percent Pine Bend interest constituted less than 16 percent of AFLP's NAV and was only 1 of 15 real estate investments that on Dec. 1, 1997, were held by AFLP, and lack of control and lack of marketability discounts at both the Pine Bend level and the AFLP parent level are appropriate.

8. *Estate of Murphy v. United States*, 2009 WL 3366099 (D.C.W.D. Ark. 2009) (Not Reported in F.Supp.2d)

(a) Facts. Decedent formed an family limited partnership ("FLP") to centralize management and protect against dissipation of his family assets. Decedent transferred his interests (then worth about $90 million) in a publicly traded oil company (in which he held significant shares), a timberland and farmland company traded on the New York Stock Exchange (in which he owned approximately 3% of the stock) and a bank (in which he held a .3% interest) to the FLP (directly or through the LLC that was the general partner). Decedent retained assets worth about $130 million. Decedent, individually and as trustee of several revocable trusts, acquired a 96.75% limited partnership interest in the FLP. A new LLC, owned 49% by decedent and 51% by two of his children, held a 2.25% general partnership interest. At decedent's death, he owned a 95.25365% limited partnership interest in the FLP, and the LLC owned a 2.28113% general partnership interest. Subsequently the decedent died and at the time of his death the assets in the FLP had increased to approximately $131.5 million. His estate reported decedent's 95.25365% limited partnership interest in the FLP at $74,008,000 (using a 41% discount). The Service maintained that the assets of the FLP were includable in the estate under §§2036(a)(1) and (a)(2) of the Internal Revenue Code of 1986, as amended (the "Code").

---

[5] In *Janda v. Commissioner*, T.C. Memo. 2001-24, the taxpayers each made gifts of 6,850 shares of the common stock of St. Edward Management Co. ("St. Edward") to each of their four children. Prior to the gifts, the taxpayers were the largest shareholders in St. Edward, each owning 23.74% of its outstanding capital stock. Furthermore, each of their four children owned 13.13% of the outstanding capital stock of St. Edward prior to the gift. Each gift was for 5.27% of the total outstanding stock so that after the gifts, the four children each owned 23.67% of the outstanding shares with the taxpayers each retaining 2.67% of such outstanding stock. St. Edward was a holding company which owned 94.6% of the outstanding common stock of the Bank of St. Edward (the "Bank"). No evidence was presented by the taxpayers for any discounts at the lower tier level for St. Edward's 94.6% interest in the Bank. At the upper tier level, the Tax Court allowed a combined discount for lack of control and lack of marketability of 40%.

(b) District Court's Decision.

(i) For the reasons set forth in its opinion, the District Court held that the transfer to the FLP satisfied the bona fide sale exception to §2036.

(ii) The FLP was valued based on net asset value with appropriate lack of control/marketability discounts. The net asset value of the interests in the three corporations was determined with Rule 144/blockage discounts of 5%, 10.6% and 1.3%, respectively. The estate's 95.25365% limited partnership interest was valued by applying a 12.5% lack of control discount and a 32.5% lack of marketability discount, for a combined seriatim discount of 41% (the discount utilized by the estate's expert).

(iii) The estate's interest in the LLC was determined after applying two levels of discounts: (A) a 20% lack of control/marketability discount for the general partnership interest owned by the LLC, and (B) a 11.1% lack of control and 32.5% lack of marketability discount (a combined discount of 40%) for valuing the estate's interest in the LLC. The overall combined discount was 52% (the discount utilized by the estate's expert).

9. Comment on above Decisions

In general, the Service takes the position that multi-level discounts are to a certain extent duplicative. However, in a majority of the above cases, even the Service's experts applied a certain level of multi-tiered entity discounts.

B. Federal Tax Decisions Largely Denying Multi-Level Discounts

1. *Martin v. Commissioner*, T.C. Memo. 1985-424

(a) Facts. Taxpayers made gifts of the voting and non-voting common stock of Arbor, Inc. ("Arbor"). Taxpayers held a non-controlling interest in Arbor. Arbor owned 4,000 acres of timberland and non-controlling interests in seven closely held corporations. Such interests constituted approximately 75% of Arbor's total assets. The closely held corporations in which Arbor held non-controlling interests included one corporation that was the parent of six corporations that operated 12 lumber centers in three states, one corporation that owned or leased almost 200,000 acres of Louisiana timberland, and a corporation that, in addition to owning shares of stock in another of the controlled corporations, owned 60,000 acres of timberland and operated a sawmill. Other controlled corporations owned thousands of acres of timberland or were in the land development or home construction and sale businesses. The stock transferred by the taxpayers represented approximately 9% of Arbor's outstanding shares and represented minority interests in each class of Arbor stock.

(b) Tax Court's Decision. The Tax Court rejected the taxpayer's position as to upper tier discounts by stating:

> …We reject petitioners' contention that because the gifted shares represent only minority interests in Arbor, a closely

> held corporation, 'second stage' discounts of 50 percent for lack of marketability and minority interest are applicable at the Arbor level in addition to the 50-percent discounts applied by petitioners to the shares of the underlying corporations. Upon careful examination of the minority interests in Arbor transferred by petitioners, we conclude that the second stage 50-percent discounts are mostly duplicative of the 50-percent discounts applied at the level of the underlying corporations and, therefore, they unreasonably reduce the value of the Arbor shares.
>
> Arbor's investment interests in the seven underlying corporations, which represent minority interests in each of the corporations, comprise approximately 75 percent of Arbor's total assets. Petitioner recognizes Arbor's minority interest in each of the corporations, and the lack of marketability of the shares of each, by applying a 50-percent discount at the level of the underlying corporations. Even had petitioners transferred a majority interest in Arbor, the holder of a majority interest would still be unable to exercise control over the seven underlying corporations. In addition, the lack of marketability of the Arbor shares depends largely on the lack of marketability of the shares of the underlying corporations. 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. We think, therefore, that respondent's application of a 70-percent discount at the level of the underlying corporations is a sufficient marketability/minority discount. [Emphasis Added]

The Tax Court added however that a 5% discount for the transferred indirect minority interest in the 4,000 acres of timberland owned directly by Arbor was appropriate[6]. However,

[6] The Tax Court stated:

> …We do think, however, that a small second stage discount of approximately 5 percent is appropriate at the Arbor level to reflect the transferred indirect minority interest in Arbor's timberland, the value of which comprises less than one-quarter of Arbor's total assets. Any transferred interest in Arbor's timberland obviously could not have been addressed at the level of the underlying corporations inasmuch as it is held by Arbor, not the corporations. By applying discounts only at the level of the underlying corporations, respondent ignores the fact that the interest in Arbor's stock transferred by petitioners affords no control over the management or liquidation of Arbor's timberland. Thus, we agree with petitioners, at least with respect to the interest transferred in Arbor's timberland, that a small second stage discount is appropriate, albeit a much smaller one than advocated by petitioners.

this was merely a discount to reflect that Arbor had no control over the sale or liquidation of the timberland[7].

2. *Estate of O'Connell v. Commissioner*, T.C. Memo. 1978-191, *aff'd on this point, rev'd on other issues* 640 F.2d 249 (9th Cir. 1981)

(a) Facts. The estate of the decedent owned 95.3% of the outstanding common stock of Capri, Inc., a holding company owning various pieces of real estate, a portfolio of securities, several nonoperating subsidiaries, and a 74.31% interest in Glacier General Assurance Company ("Glacier"), a multiple line fire and casualty insurance company. The taxpayer's expert argued that a majority interest in Capri, Inc. would sell at a price recognizing certain discounts.

(b) Tax Court's Decision. At the lower tier level, the Tax Court applied a lack of marketability discount of 30% to the value of Glacier rather than the 20% discount argued by the Service's expert based on the failure of Glacier's public offering shortly before the valuation date. The Tax Court rejected the taxpayer's argument for a discount at the upper tier level, stating:

> …We are not convinced that the decedent's 95 percent controlling interest in the stock was given sufficient consideration by petitioner…
>
> We are similarly unconvinced that the approach utilized by Dr. Pratt in his appraisal of Capri made sufficient allowances for the decedent's controlling interest…
>
> This approach might be applicable for minority stock interests, see Estate of Heckscher v. Commissioner, 63 T.C. 485 (1975), but here we are valuing a 95 percent majority interest where recognition of the asset value is crucial to any purchaser who, having effectively acquired the company, has an obvious interest in the net worth that is beyond the interest in the security…

The Tax Court further noted that:

> …Glacier General is Capri's principal operating subsidiary. Since we have already provided for a discount with regard to Glacier General's closely-held stock, the result of an additional discount for the aggregate assets of Capri, which

---

[7] The Tax Court in *Martin* also refused to allow a discount for built-in capital gains tax as there was no evidence that a liquidation was imminent, planned or even likely. See Footnote 2.

are primarily investment holdings not subject to discount, would in effect only increase the discount previously designated to Glacier General. Assuming no other reason to discount the stock, we reject such an inflated reduction.

Although it is clear that any buyer of Capri stock would be attracted by one particular asset, that of Glacier General, we find that factor minimal in comparison with the weight of other factors considered. Consequently, we do not find a discount for Capri appropriate.

3. Comment. As the Tax Court stated in *Astleford* citing *Martin* and *Estate of O'Connell,* the Tax Court is inclined to reject multiple discounts where the lower level interest constituted "a significant portion of the parent entity's assets…or where the lower level interest was the parent entity's principal operating subsidiary".

C. Non-Tax Decision

1. *In re Estate of Hjersted*, 285 Kan.559, 175 P.3d 810 (2008)

(a) Facts. Since its incorporation, Norman had owned all of the stock of Midland Resources, Inc., ("MRI"). MRI manufactured chemicals used in the treatment of water and wastewater. Subsequently, Norman and his son, Lawrence, created the Hjersted Family Limited Partnership ("HFLP"). Norman transferred all of his 500 shares of MRI to HFLP. The stock in MRI was the only asset of the limited partnership. Norman kept limited partnership interests of 96% in HFLP for himself. The remaining HFLP interests were owned as follows: 2% general partnership interest owned by Norman, 1% general partnership interest owned by Lawrence, with the last 1% limited partnership interest being owned by Lawrence.

Approximately three years after the creation of HFLP, Norman entered into a gift/sale transaction with Lawrence concerning his 96% limited partnership interest in HFLP. A portion of Norman's 96% limited partnership interest worth $675,000 (the maximum then allowable without incurring federal gift tax) was gifted to Lawrence. According to the applicable contract, the balance of Norman's 96% interest was sold at a price to be determined by later appraisal. Norman retained his 2% general partnership interest through the revocable trust for which he served as sole trustee[8].

Norman's and Lawrence's appraiser valued HFLP's only asset, the 500 shares of MRI stock, at $4,500 per share, for a total of $2.25 million. This result was reached after applying a "lack of marketability" discount of 20%. In valuing HFLP, the appraiser then applied a discount of 10% for lack of control and an additional 25% discount for lack of marketability, resulting in a combined effective discount of 32.5% for the HFLP 96% limited partnership interest value.

[8] It appears that approximately 21 months prior to the gift/sale transaction Norman transferred his 96% limited partnership interest and his 2% general partnership interest to a revocable trust of which Norman was the sole trustee. The transfer of the 96% limited partnership interest to the revocable trust seems to have been ignored in the gift/sale transaction. After Norman's illness, Lawrence subsequently became the sole trustee of the revocable trust.

Norman subsequently died, and as the gift/sale transaction occurred within two years of the death of Norman, his widow, Maryann, filed a petition for the elective share of a surviving spouse under applicable Kansas law. One of the questions in the proceeding was whether discounts were precluded in the valuation of a 96% limited partnership interest in HFLP as of the date of the gift/sale transaction between Norman and Lawrence for purposes of determining a surviving spouse's elective share.

(b) Court's Decision. The Supreme Court of Kansas held that in valuing the assets of the partnership for purposes of determining the spousal elective share, lack of control and marketability discounts were not precluded[9].

The case was then remanded back to the district court, with the requirement that the district court address the validity of the upper tier discounts. The Kansas Supreme Court held that lack of control and lack of marketability discounts may appropriately be applied if the district court on remand determines that Norman's transfer to Lawrence was based on legitimate estate and business planning and not simply a desire to disinherit Maryann. This would mean that applying discounts at both the lower tier and upper tier would then be appropriate in valuing the 96% limited partnership interest in HFLP[10].

---

[9] The court first rejected Maryann's argument that the partnership interests were unified (which may have been the result when Lawrence subsequently became the trustee of his father's revocable trust due to his father's illness).

However, the court noted:

> Control and marketability discounts are not appropriate when the purchaser is either the majority shareholder or the corporation itself…Similarly, when the result of the transaction unifies the interests of a partnership in the same individual [Lawrence], albeit as an individual and a trustee, such discounting is illusory.
>
> Where the sole asset of the partnership is corporate stock that has already been discounted for lack of marketability, no further discount is appropriate when valuing the partnership interests because the partnership did not perform a management function for such asset. See *Estate of Bongard v. Commissioner*, 124 T.C. 95, 126-29 [2005 WL 590670] (2005) (transfer of stock to a limited partnership does not satisfy bona fide sale exception to 26 U.S.C. § 2036[a] [2000]); at 567.

[10] In passing, the Kansas Supreme Court in *Hjersted*, commented:

Accordingly, the case is reversed and remanded to the district court. The court will be required to at least address the validity of Korschot's 32.5% discounts for lack of marketability and lack of control of HFLP interests, and may adjust, compromise, or even reject one or both. As several commentators have expressed when valuing closely held business interests, including limited partnerships:

> "Opinions as to value frequently are far apart especially when such opinions are requested by adversaries. In the final analysis, the outcome of each case is usually a compromise, with the Court often finding a value somewhere between the valuation sought by the taxpayer and the higher appraisal sought by the Service. Since the facts of each case will determine the outcome, it is worth noting that case law is usually available to support any position regarding valuation of an interest in a closely held business. "Hood, et al., *Valuation of Closely Held Business Interests*, 65 UMKC L.Rev. 399, 406-07 (1997) (reference work cited with approval in *Armaud v. Stockgrowers State Bank*, 268 Kan. 163, 165, 992 P.2d 216 [1999]). at 572, 573.

D. Other Possible Utilization of Multi-Level Discounts - Reduction of Built-In Gain for S Corporations under §1374 of the Code

(a) Assumed Facts. A corporation ("A Corp") desires to be treated as an S corporation pursuant to the provisions of §§1361 through 1379 of the Code. The sole shareholders of A Corp are B and C, each owning 50% of the outstanding common stock of A Corp. B is the widow of D and she recently inherited her stock in A Corp upon D's death, thus receiving a stepped-up basis in her stock in A Corp. Suppose A Corp is presently the sole member of a number of different limited liability companies ("LLCs") that are treated as disregarded entities for tax purposes. The interests in the LLCs are the sole assets of A Corp. Prior to the effective date of A Corp's S corporation election, A Corp decides to transfer one-half of its membership interests in the LLCs to B in redemption of all of B's shares of stock in A Corp. A Corp has a net operating loss carry-forward which will eliminate all of its gain on the transfer of the appreciated interests in the LLCs to B. As a result of such a transaction, B is no longer a shareholder in A Corp and A Corp and B are the sole members of the LLCs (which will then be classified as partnerships for tax purposes). Effective as of January 1st subsequent to the year in which the above transaction takes place, A Corp elects to be treated as an S corporation with C as its sole shareholder.

(b) Question Being Asked. Pursuant to the provisions of Section 1374 of the Code, a corporate level tax at the highest corporate tax bracket is imposed on an S corporation that disposes of assets that appreciated in value during the years when the corporation was a C corporation. Would discounts for lack of control and/or lack of marketability or other discounts available to A Corp as of the effective date of its S corporation election (by reducing the value of the LLC interests as of the effective date of such a corporation's election) have the effect of reducing the potential built-in gain of A Corp in the event of a future sale by A Corp of its interests in any of the LLCs during the period that A Corp is an S corporation?

(c) Effect of Treas. Reg. § 1.1374-4(i)(2)(i).

(i) Treas. Reg. § 1.1374-4(i) provides that an S corporation owning an interest in a partnership (which should include an interest in a limited liability company taxed as a partnership) must treat its distributive share of the partnership's items as recognized built-in gain or loss to the extent that the S corporation's distributive share would have been treated as such if the items originated in, and were taken into account directly by, the S corporation. These

---

The court then added:

> In short, the district court may possibly find: that the HFLP interest transfers were manifestations of Norman's legitimate business and estate planning; that they would be entitled, at least for transfer tax purposes, to discounts for marketability and control; and that a similar rationale would allow such discounts for valuing those assets in the augmented estate for the spousal elective share purposes. at 577.

look-through rules generally apply only to the extent that the S corporation had built-in gain or loss in its *partnership interest* on the effective date of the S corporation election. Accordingly, in the event the S corporation sells a partnership interest, the gain on the sale of the partnership interest is limited to the amount of the gain that the S corporation would have realized had it sold such a partnership interest at its fair market value on the effective date of its S corporation election. See Treas. Reg. §1.1374-4(i)(2)(i).

(ii) However, Treas. Reg. § 1.1374-4(i)(2)(i) further provides that this rule "does not apply if a corporation forms or avails of a partnership with a principal purpose of avoiding the tax imposed under section 1374." Pursuant to such provision, the Service may take the position that the principal purpose of the creation of LLCs taxable as partnerships was to avoid built-in gains tax by the creation of a tier of discounted entity valuations. Thus, the Service would apply the look-through approach on a sale of a partnership interest without limiting the built-in gain to such gain that the S corporation would have realized had it sold each partnership interest at its fair market value (which would arguably be reduced by such discounts) on the effective date of its S corporation election as compared to the fair market value of the underlying assets owned by such a partnership on that date.

(d) Possible Service Argument. In this example, could the Service argue under the rationale of Treas. Reg. § 1.1374-4(i)(2)(i) that since B and C in essence each still directly or indirectly retain a 50% interest in all of the assets of the LLCs, a principal purpose of the conversion of the LLCs from disregarded entities to partnerships was to reduce the built-in gains tax under Section 1374 of the Code? Accordingly, the creation of a tier of LLCs taxable as partnerships would not reduce the potential built-in gain[11].

(e) Additional Example. Assume the same facts in the above example, except that C is the sole shareholder of A Corp and A Corp sells C a 50% interest in the LLCs. How should the purchase price for such interests be calculated? Should these interests be subject to various discounts? Furthermore, should the LLC interests retained by A Corp be subject to discounts as 100% of the interests in the LLCs are owned directly and indirectly by C[12]? Would Treas. Reg. § 1.1374-4(i)(2)(i) apply so as to eliminate any reduction in the built-in gain resulting from the utilization of discounts by increasing the value of the LLC interests as of the effective date of the S corporation election to their respective underlying asset values? Would the answer be the same if C were to transfer an aggregate 5% stock ownership in A Corp to one or more of its key employees or if A Corp were to transfer an aggregate 5% membership interest in one or more of the LLCs to one or more of its key employees?

[11] Treas. Reg. 1.701-2(b) grants the Commissioner the authority to recast transactions for Federal income tax purposes "if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal income tax liability in a manner that is inconsistent with subchapter K."

[12] Under the rationale of recent cases, the value of C's stock in A Corp should be discounted by A Corp's potential built-in gain. See Footnote 2.

III. Lack of Marketability Discounts for Wholly Owned Entities

A. Federal Tax Decisions Pertaining to Discounts for Wholly Owned Entities

1. *Estate of Colley v. Commissioner*, T.C. Memo. 1980-107

(a) Facts. Until July 26, 1971, the deceased Woodrow Colley ("Woodrow"), was the sole shareholder of Woodrow Colley Lumber Co. ("Retail") and Colley Wholesale Lumber Company ("Wholesale"). Retail was involved primarily in the construction and home sales business, while Wholesale's business appears to have consisted primarily of the wholesale sale of lumber. In 1974 and 1975 a series of calamitous events occurred, including an uninsured fire loss in a warehouse of the lumber companies, a flood and the bankruptcy of two major customers.

Woodrow died on August 4, 1975. The value of Woodrow's 100% interest in Wholesale was reported at $425,000 on the federal estate tax return filed after Woodrow's death. In this valuation, Retail was shown as a subsidiary of Wholesale; however, it appears that the Service treated both corporations as owned by Woodrow.

(b) Tax Court's Decision. Both the taxpayer and the Service agreed to "…a 25 percent discount of the final figures to take into account the lack of marketability of closely held stock and the key role Woodrow had played in the business." The Tax Court then determined that the value of the interests of Woodrow in Wholesale and Retail was $375,000 for all of Woodrow's shares[13].

2. *Estate of Jephson v. Commissioner*, 87 T.C. 297 (1986)

(a) Facts. The decedent owned all of the stock in two investment companies, the assets of which consisted solely of cash and marketable securities.

(b) Tax Court's Decision. The Tax Court held that the value of the stock in each company was its net asset value less the costs of liquidation[14]. The Tax Court stated:

> After considering all relevant facts and circumstances, we find that the date of death values … are their respective net asset values, less the cost of liquidation. The factors that persuaded us in reaching this finding are: (1) all the assets of both investment companies were liquid assets, i.e., cash

[13] Incidental to its determination, the Tax Court held that an alleged $338,631 obligation of Woodrow to the corporations was not a valid obligation of Woodrow, thus reducing the values of the two corporations.

[14] The FMV of the stock of one of the corporations before liquidation expenses was $7,057,532 with liquidation expenses of $46,164 (.65%), resulting in a final FMV of $7,011,368 for such corporate stock, while the FMV of the stock of the other corporation before liquidation expenses was $2,971,458 with liquidation expenses of $48,672 (1.67%), resulting in a final FMV of $2,922,786 for such corporate stock.

and marketable securities; (2) neither corporation had any liabilities which had to be seriously considered in valuing the companies; (3) the decedent's 100 percent ownership of both companies gave her (or her estate) the unqualified right to liquidate both companies at any time. In our opinion, neither the decedent nor her estate nor a hypothetical seller would have sold the stock of either company for less than that which could have been realized through liquidation. We further believe that a hypothetical purchaser would be willing to pay such an amount.

We recognize that the value of an interest in an investment company is not always equal to its proportionate share of the company's net asset value. For example, we have applied a discount where a minority interest was being valued….We have also allowed a discount for the nonmarketabitity of an investment company's stock, particularly where its assets consist of real estate or other non-liquid assets. *Estate of Piper v. Commissioner*, 72 T.C. 1062 (1979); *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982). Here, however, there is neither a minority interest nor any non-liquid assets.

…

Petitioner next argues that a discount for nonmarketability is warranted. <u>Petitioner contends that marketable securities and cash, when held in corporate solution, are not readily marketable. This argument ignores the fact that complete ownership of each corporation enables petitioner to obtain, at any time, direct ownership of the corporate assets either through a partial or complete liquidation or through a dividend in kind</u>. at 303, 304. [Emphasis Added]

3. <u>*Estate of Mosher v. Commissioner*, T.C. Memo. 1988-24</u>

(a) <u>Facts</u>. The decedent owned 100% of the stock of a corporation owning 50% interests in two office buildings, which were basically the only assets of the corporation. The decedent's estate sought a 10% discount in the value of the buildings for the burdens of joint ownership and a 10% discount for the lack of marketability of the stock of the nonlisted, closely held corporation.

The estate argued that the properties, which represented the value of its shares, should be discounted by 10% to reflect the fact that shares in a non-listed closely-held corporation are less marketable than shares in a public corporation, and in supporting this contention cited a long list of cases. The Service argued that the fact that the corporation is closely held is not a proper basis for a discount of its underlying assets or net asset value, as the mere fact that the properties are held in the corporate form does not merit an additional discount or distract from the fact that petitioner owned 100% of the stock.

(b) Tax Court's Decision. The Tax Court agreed to the 10% discount for the burden of joint ownership, but declined to apply an additional discount for lack of marketability of the stock as such an additional discount would be duplicative[15].

4. *Estate of Dougherty v. Commissioner*, T.C. Memo. 1990-274

(a) Facts. The gross estate of the decedent, Albert L. Dougherty ("Albert"), as reported on its federal estate tax return, included decedent's 100% beneficial interest in a Revocable Trust (the "Trust"). The sole asset of the Trust on the date of Albert's death was 100% percent of the outstanding stock of A.L. Dougherty Co., Inc. ("Dougherty Inc."). The assets of Dougherty Inc. as valued by the estate's appraiser largely consisted of certain notes receivable with an FMV of $1,310,700; marketable securities with an FMV of $250,000; long term investments consisting of three parcels of land (also subject to discounts), two of which were wholly owned by Dougherty Inc. and one of which (the Lee County Florida Parcel) was owned 50% by Dougherty Inc. (which was adjusted to a .6718 discounted value); and a partnership interest in Estero Bay Land, Ltd. ("Estero") having an FMV of $1,838,000.

The estate's appraiser concluded that the FMV of Dougherty Inc.'s net assets was $6,620,000. The appraiser determined that a 10% discount for incremental management costs due to the nonhomogeneous nature of the assets of Dougherty Inc., was appropriate. The estate's appraiser also concluded that a 25% discount for lack of marketability was appropriate. Accordingly, the estate's appraiser reduced the total asset value of $6,620,000 by 35% to reach a value for the stock of Dougherty Inc., of $4,300,000.

The appraiser for the Service reflected a co-tenancy discount of 15% for the Lee County, Florida Parcel. To value the Dougherty Inc. stock, the Service's appraiser reduced the net asset value by $300,000 to reflect operating and liquidation costs, and then reduced the resulting amount by a 20% liquidation discount.

---

[15] In reaching this result, the Tax Court stated in *Estate of Mosher* that:

> We have already applied a 10 percent discount to the value of these buildings to reflect the burden of joint-ownership. This discount lowered the value of the properties, and thus the net asset value of the corporation. This, in turn, lowered the value of the stock of the closely-held corporation. If petitioner were to sell the properties, the difficulty in finding a purchaser would stem from the joint ownership and not from the fact that the stock is closely held because petitioner is the 100 percent owner of the stock and has control over it.
>
> As we have already considered the burden of joint ownership as a basis for a discount, and this discount is reflected in the net asset value of the corporation and, hence, the value of the stock, we decline to grant petitioner the additional 10 percent discount it requests. To do so would be to adopt this circular argument, an argument we find unpersuasive.

(b) Tax Court's Decision. The Tax Court stated that the instant case differed from *Estate of Jephson v. Commissioner*, (see discussion in Section 3.A(2) above), in that the assets of Dougherty Inc., were primarily real estate and other nonliquid assets. Accordingly, the Tax Court found that *Estate of Jephson* did not support the Service's position by noting:

> Instead, the instant case is similar to the situations we mentioned in Estate of Jephson v. Commissioner, supra, where a discount for nonmarketability would be appropriate because the assets of A. L. Dougherty Co., Inc. consist largely of real estate and other nonliquid assets. Consequently, we do not agree with respondent that the correct way to value the A. L. Dougherty Co., Inc., stock is to determine the net asset value (exclusive of operating and liquidation costs) and then apply a 20-percent discount for liquidation costs[16].

The Tax Court held that a 25% discount for lack of marketability and a 10% discount for incremental costs were appropriate. The Tax Court also found that none of the real properties owned entirely by Dougherty Inc. were subject to further discounts, but that a 15% discount was necessary to reflect the co-tenancy of the Lee County Florida Parcel[17].

5. *Estate of Bennett v. Commissioner*, T.C. Memo. 1993-34

(a) Facts. Among the assets of the decedent listed on the decedent's estate tax return was the decedent's interest in the decedent's Memorial Trust. As of the date of the decedent's death, the principal asset of the Memorial Trust was its stock in Fairlawn Plaza Development, Inc. ("Fairlawn"), representing all of the outstanding stock of Fairlawn. On the decedent's federal estate tax return, the co-executor valued the Fairlawn stock at $2,556,000. Among the assets of Fairlawn were a neighborhood shopping center and nearby parcels known

---

[16] The Tax Court also noted that:

> Respondent contends that because the Trust held 100 percent of the A. L. Dougherty Co., Inc., stock, no discount for lack of marketability was applicable. Respondent bases this contention on Estate of Jephson v. Commissioner, supra. As we discussed previously, rather than supporting respondent's position, Estate of Jephson v. Commissioner, supra, supports petitioner's position that a discount for lack of marketability is applicable. We acknowledged in Estate of Jephson v. Commissioner, supra, that a discount for nonmarketability may be applicable where the assets of an investment company consist of real estate or other nonliquid assets. We agree with Mr. Lawinger that a 25-percent discount for lack of marketability is appropriate for the stock of A. L. Dougherty Co., Inc. We also agree with Mr. Lawinger that a ten-percent discount for incremental management costs is appropriate. The assets of A. L. Dougherty Co., Inc., are varied and there would be management costs that should be taken into account in valuing the stock.

[17] It is somewhat unclear whether any discounts were utilized in the value of Dougherty Inc.'s partnership interest in Estero. Taxpayer's appraiser valued the 40% partnership interest in Estero at $1,838,000. The Service's appraiser valued the partnership interest at $1,764,000.

as "Fairlawn Plaza" (portions of which were also known as the "Strip"), the fee simple interest, subject to a long-term ground lease (which was subordinated to the ground lessee's mortgage), of the adjoining enclosed mall known as "Fairlawn Shopping Mall" and accounts and notes receivable. It was public knowledge that Fairlawn Plaza was experiencing many financial difficulties, which commenced at least a year or two before the decedent's death. After determining the FMV of Fairlawn's assets less its liabilities, the estate's appraiser deducted estimated costs of liquidation (a 5% discount for commissions, a 25% discount for losses on liquidation and a 3% discount for the costs of overhead and sales costs) to come up with an estimated net value on liquidation. The estate's appraiser then applied a 15% discount for lack of marketability to arrive at an estimated value of Fairlawn's equity after debt, which he rounded to $2,556,000.

In his determination of the FMV of a 100% interest in the common stock of Fairlawn, the Service's appraiser relied exclusively upon the asset-accumulation approach. As a result, he concluded that the stock of Fairlawn was worth approximately $5,000,000. The Service's appraiser stated that a discount for lack of marketability was not appropriate because there was no illiquidity for stock of a corporation that was 100% owned by one person. He also concluded that a discount for the costs of liquidation was not warranted because liquidation in this case was only speculative.

(b) Tax Court's Decision. The Tax Court determined that neither *Estate of Jephson* nor *Estate of Mosher* were controlling[18]. The Tax Court noted in *Estate of Bennett* that:

> In *Estate of Dougherty v. Commissioner, su*pra, a much different factual situation was presented. The decedent in that case had a 100-percent beneficial interest in a trust that owned all of the stock of A.L. Dougherty Co., Inc. The corporation's assets consisted of notes receivable, securities, fixed assets, long-term investments, and partnership interests in real estate, as well as other miscellaneous assets. The estate's appraiser valued each of the assets and liabilities of the corporation, and then concluded that a 10-percent discount for incremental management costs due to the nonhomogeneous nature of the assets was appropriate. The appraiser also applied a 25-percent discount for the lack of marketability. This Court agreed with the application of both discounts in that case because the assets of the company were so varied, consisting of real estate and other nonliquid assets. We specifically pointed to our acknowledgement in *Estate of Jephson v. Commissioner*, *supra*, that a discount for nonmarketability may be applicable where the assets of an

[18] The Service argued that *Estate of Jephson* and *Estate of Mosher* applied to the instant transaction and that lack of marketability discounts should not be allowed.

investment company consist of real estate and other nonliquid assets.

The holdings in these two cases are not inconsistent but are based on each case's own peculiar facts and circumstances…In contrast, we found that the corporate form in *Estate of Dougherty v. Commissioner*, *supra*, played a significant role. We found that the varied assets of the company would generate management costs that should be taken into account in valuing the stock. Furthermore, we recognized that the value of an interest in an investment company is not always equal to its proportionate share of the company's net asset value.

So too in this case, our holding that a lack of marketability discount is warranted is based on a totality of the facts presented. Here, we have a real estate management company whose assets are varied and nonliquid. We think that the corporate form is a quite important consideration here: there is definitely a difference in owning the assets and liabilities of Fairlawn directly and in owning the stock of Fairlawn, albeit 100 percent of the stock. We think some discounting is necessary to find a buyer willing to buy Fairlawn's package of desirable and less desirable properties. Thus, the line of cases in which we have recognized that difficulties arise in holding nonliquid assets in the corporate form, even in the 100-percent ownership situation, is applicable in this case. We have recognized that

> The lack of marketability discount * * * is designed to reflect the fact that there is no ready market for shares in a closely held corporation. * * * it should be borne in mind that even controlling shares in a nonpublic corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock. * * * Estate of Andrews v. Commissioner, 79 T.C. 938 (1982) at 953. [Emphasis Supplied]

Although the Tax Court did not apply a discount for speculative liquidation costs, it did apply a 15% lack of marketability discount[19]. Based on the record as a whole it concluded that the FMV of the Fairlawn stock as of the date of the death of the decedent was $3,758,386.

B. Other Considerations

1. Reaction of Appraisers.

(a) In discussions with a well respected appraiser who appraises both the value of real estate and the ownership interest in the entity holding such real estate, the appraiser was reluctant to discount the value of an LLC wholly owned by the deceased which owned 100% of the ownership interests in two subsidiary LLCs. Each LLC owned an office building in the Baltimore metropolitan area. The appraiser was unwilling to utilize the rationale of the holdings in *Estate of Dougherty* or *Estate of Bennett*, arguing that there was a requirement that the parent LLC needed to be an investment company with more diverse assets.

(b) However, in discussions with valuation experts associated with two local accounting firms, when presented with the basic facts, both were willing to value the ownership interests in a parent LLC (owned 100% by the deceased) after a reduction for a lack of marketability discount.

2. Other Situations Where Valuation Utilizing Discounts for Lack of Marketability may be Desirable.

(a) Determination of the FMV of an interest in an entity under a Buy-Sell Agreement with an appraisal procedure where there is no direction to value the interest as if the property of the entity had been sold at its FMV, the liabilities of the entity sold and the person whose interest is to be acquired receives proceeds in the liquidation of the entity.

(b) Determination of the FMV of an interest for purposes of compensation, such as in *Gow*, including any valuations that may be required under Section 409A of the Code.

(c) Valuation of closely held business interests in litigation and family law disputes.

[19] The Tax Court refused to take liquidation costs into consideration as the parties had agreed that there was no reasonable prospect of liquidation in this case.