

*Winter 2011-12 Newsletter*

**DOL/IRS abandons efforts to make ESOP valuation professionals fiduciaries...but will re-propose the rule at a later date !**

The U.S. Department of Labor's Employee Benefit Security Administration will re-propose its rule by defining "fiduciary" according to a September 19, 2011 press release. This is officialdom's answer to generally negative comments from the affected parties: re-draft the rules, but do not necessarily take the comments into account.

There is no reason to make independent appraisers both advisers and fiduciaries, a difficult position at any rate. Appraisers are advisers who follows specific DOL and IRS rules, and separate ESOP trustees are supposed to make sure the participants's interests are taken care of according to law and regulations. Assuming, of course that the regulators actually supervise the trustees.

If the rules are eventually set which are similar to those proposed, then this and many other appraisers will exit the business of advising ESOPs on the value of their holdings.

**The IRS Publishes its own DLOM Job Aid**

On September 25, 2009, an IRS team produce a remarkable document entitled "*Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals.*" And you thought only the accountants had job aids ! The IRS job aid has since been posted on the IRS web site, and it follows that it could be construed as authoritative.

A review of the job aid reveals that it is a comprehensive compilation on the subject of the DLOM, including the acceptance/rejection of the many available methods by the Tax Court, as well as the IRS team's comments of each method's validity. Not surprisingly, IRS does not believe many methods lead to valid discounts and independent, non-government appraisers and their clients should take notice. Somewhat arbitrarily, the available methodologies for determining the right DLOM for a given assignment are segregated in 4 baskets:

Benchmark Approaches:	Restricted Stock Studies Pre-IPO studies Restricted Stock Equivalent Analysis Cost of Flotation
Securities Based Approaches:	Long Term Equity Anticipation Securities [LEAPS] <i>Longstaff</i> study <i>Chaffee</i> study Bid-Ask Spread method
Analytical Approaches:	<i>Karen Hopper Wruck</i> <i>Hertzel and Smith</i> <i>Bajaj, Denis, Ferris and Sarin</i> <i>Ashok B. Abbott</i>
Other Approaches	QMDM [Mercer] NICE NERA Partnership Profiles MergerStat

Since the Tax Court has indicated that it prefers market-based approaches which infer relationships gleaned from the markets and are then applied to the subject firm, it is somewhat surprising to hear the Service condemn most of the benchmark approaches, even as the Service highly recommends that customization to the subject firm is a must, i.e. do not just apply averages. In other words, the appraiser must analyze the data and determine what may or not apply to the subject interest.

In particular, the job aid severely sharply condemns the FMV Opinion database and method as generally inapplicable. The pre-IPO approach is also generally condemned as being too time-specific, and the cost-of-flotation as too theoretical. Again, the Tax Court has said these things before.

Unfortunately, the job aid was written too early to discuss the Pluris DLOM database methodology, which this firm has had good luck with recently [see next article.] This is particularly important since the overlap between the FMV Opinion and Pluris databases is unknown.

The Job Aid was understandably negative about listed long term put options, which by definition can not apply to private companies. Other option-based methods such as *Longstaff* and *Chaffee* are also being dismissed by the IRS group as being too sensitive to volatility, which is impossible to measure for a private firm. Bid-Ask spread analysis measures illiquidity, not the DLOM. Only the *Ashok B. Abbott* method, written up in an 2006 academic study, is not criticized by the job aid; we look forward to looking at it critically when it is further reviewed.

The IRS job aid is a useful compilation of how the DLOM can be calculated. The subject is important and should clearly be taken seriously, as the Service obviously does. However; the job aid does not add much to the art.

### **The Pluris DLOM Database**

In the past year or so, this firm has started using the Pluris methodology to support many discounts for lack of marketability. We have done so because the database allows a customization of restricted stock data so as to only take into account comparable restricted stock transactions as determined by capitalization or transaction size, industry, size of revenues or profitability, based on relevant facts and circumstances.

It has been clear for some time that pre-IPO studies were too time-specific to have any relevance to private companies and, perhaps as a result, generally produced large discounts. Other restricted stock databases certainly deserve criticism because they include transactions involving the issuer, such as Private Investment in Public Equity Securities which reflect the [generally poor] financial condition of the latter.

The Pluris universe of restricted-stock transactions includes hedge fund to hedge funds deals, as well “secondary markets” -based transactions only recently made available. Pluris obtains some of its data from SecondMarket© and others and each transaction is verified to be independent of the issuer, i.e. terms are established between a buyer and a seller. Buyers and sellers in the database have the same level of information, no new money is raised for the issuer, and there is no impact on financial condition. Since blocs are typically small, there is no effect on control. Hence, Pluris says, the discount reflects the DLOM only.

Restricted stocks discounts are defined as the difference between the price of a publicly-traded stock and that of the same stock, when issued with trading restrictions through private placements, employee stock benefit plans or other reasons. The courts have admonished appraisers not to use averages or medians of a published study because of the lack of information on variations from the mean, because of the relationship between the subject

interest and the interest of the given study, industry specific factors and because of differences in volatility at the valuation date versus the dates covered by the study. Pluris allows appraisers to comply with that directive and the database includes over 3,000 transactions since 2001.

Pluris allows the appraiser to analyze the factors which may give rise to a discount and select transactions from comparable industries, and/or from transactions comparable in size to the subject, or similar capitalization size. It also allows to eliminate transactions involving non-operating firms, i.e. firms with no historical revenues. Factors to consider and explain include any relationship between the data and the subject interest, how the discount differs/does not differ by industry sector.

We have used the Pluris database for valuation of special entities such as real estate investment vehicles as well as operating companies in manufacturing, distribution and internet content industries. This method has not been "vetted" by a court decision as of date, and it is possible that data about my next client's industry simply will not be available in Pluris, requiring use of another method.

The Pluris model adds to the discount observed in the appraiser-driven sample of comparable restricted-stock transactions an increment designed to account for the fact that all restricted stock transactions will - at the end of the trading restriction period - become public again, while we typically appraise closely-helds. That increment is conservatively estimated by reference to the larger size transactions, which take longer to monetize. The resulting so-called private equity discount increment is indeed conservative, generally at a few percentage points.

#### **Liljestrand v. Commissioner T.C. Memo 2011-259**

Afer retiring from the practice of medicine in Hawaii, Dr. Liljestrand invested in 14 properties in 4 states. Several years later, his eldest son became the manager of the properties. More than a decade later, a partnership was formed and the properties were transferred to it from a revocable trust in exchange for the initial partnership interests in 1997. Each of the 4 children obtained their partnership interest through a series of gifts in 1998 and 1999, which were valued in excess of the annual exclusions. Despite having transferred title to the properties to the partnership, the parties continued to treat the real estate as an asset of the trust, and ignored certain formalities of the new entity. At issue is whether the value of the assets transferred by Dr. Liljestrand to the partnership should be included in the value of his gross estate under the bona fide test of IRC 2036.

The estate argued that it had 3 non-tax purposes for setting up the partnership, and all 3 were rejected by the court.

[a] Central management of the real estate and long term employment of the eldest son: The Court did not agree that the partnership centralized management, since the son-manger was already the manager and trust administrator before the entity was formed. Further, since he had a personal interest in the properties and acted as trustee, a continuing conflict of interest both before and after formation existed, the latter vehicle did not enhance his chances of continuing employment as manager.

[b] Avoidance of partition or division: The doctor's counsel relied on the Hawaii partition action statutes as the basis for the added protection. The Court noted that similar legal research was not conducted in the other states where the partnership owned property. Further, upon Dr. Liljenstad's death, the real estate would have ben distributed to the residuary trust and the children's trusts, and neither could terminate until the death of the last of his living child. Accordingly, the beneficiaries would not hold real estate as joint tenants or tenants-in-common and could never be joint tenants or tenants-in-common. Finally, the court could not find any evidence that any child had any interest in seeking a partition.

[c] Creditor protection: The court found no evidence that Dr. Liljestrand or any other partner were concerned with creditor claims, and the estate could not name a single creditor or even an activity which could open them to potential liability.

The Court emphasized the failure to respect partnership formalities as evidence that the transfers were not bone fide sales. Some of the mis-steps included co-mingling partnership and personal funds, as the partnership's checking account was opened 2 years after formation, partnership assets being used to pay personal expenses, lack of meetings, and the Doctor's reliance on partnership funds to maintain his lifestyle. The Court also noted that interest credited to each partner was not proportionate to the value of assets contributed, as the 1997 valuation was ignored in capitalizing the partnership, and the eldest son even obtained a small general partner interest gratis.

One needs to follow FLP rules in order to avail oneself of the exemption. The text of the decision is available at <http://www.ustaxcourt.gov> click on Opinions Search, then enter "Liljestrand". See also <http://www.NYNJCT-BV.com/LiljestrandMemo.TCM.WPD.pdf>

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**J.L. Pierson, ASA is an experienced business appraiser covering the tri-state area from his base in Darien, CT. His clients are closely-held businesses with revenues of up to \$250 million, as well as owners of family limited partnerships and professional corporations. He specializes in business valuation for estate/gift tax, succession planning, and litigation such as shareholder disputes and divorce, corporate development and other transactional support purposes.**

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