



## Discounts for Lack of Marketability — A New Approach

If it's not liquid, what's it really worth? That's the question behind the concept of discounts for lack of marketability. A marketability discount applied to the estimated value of a business is designed to reflect the fact that shares in a privately held company are less liquid than in a publicly traded company. The less liquid the asset, the lower its value.

In order to arrive at an appropriate percentage discount for lack of marketability, business valuation professionals have historically turned to two empirical sources to guide their assessments: restricted stock studies and "pre-IPO" studies.

Recently, a new approach has been suggested that uses both types of data to support the discount. This new approach is of great interest in the business valuation world because discounts for lack of marketability are the most common — and frequently the largest — financial issue disputed by the IRS.

### The New Option

IRS discounts for lack of marketability have typically relied on restricted stock studies, which attempt to quantify the difference between the sale price of restricted stock and the sale price of the same stock in the open market on the same date. The problem with relying too heavily on the averages provided by this data is that they don't reflect long holding periods for most minority interests in closely held companies — a necessary factor to consider when determining the magnitude of a discount for marketability.

A new database created by valuation expert Shannon Pratt is the most comprehensive pre-IPO database available. Known as the Valuation Advisors' Lack of Marketability Discount Study, it includes data on more than 2,400 transactions reflecting all IPOs since 1995.

Using this study, business valuation professionals can choose specific transactions that most closely resemble the business under evaluation. Therefore, the resulting calculations are based on more thorough and detailed data, which is more specific to the interest being valued.

If restricted stock studies are considered, to reflect the longer holding period Pratt also suggests using the highly detailed data from The FMV Restricted Stock Study. This data reflects the concept that the larger the block of stock, the longer it will take to liquidate it, and thus, the higher the discount.

### **Okerlund v. United States**

The use of this new valuation approach has been validated in court in *Okerlund v. United States*, a case involving an estate-related business valuation challenged by the IRS. While both the estate experts and the IRS experts used restricted stock and pre-IPO studies, the IRS relied more heavily on restricted stock studies, which didn't properly reflect the privately held nature of the stock in question.

The estate's expert, who happened to be Shannon Pratt, argued that his pre-IPO studies had more weight because they were more relevant to the Okerlund situation. The court held that it was proper to use the pre-IPO study data as suggested by Pratt, stating, "Pre-IPO discounts ... are based on purely private transactions before a company enters the public market, a situation more comparable to closely held companies ..."

The fact that the court liked the more detailed Valuation Advisors' Lack of Marketability Discount Study data opens the door for more valuations to use this study as a source. Business valuation professionals are pleased to have more specific data, which has historically been given more credibility by the tax court.

*Our business valuation professionals are leaders in their field and up-to-date on the latest research in the valuation arena. Please contact us and we will be happy to answer any questions you may have regarding this new approach.*