

# TCA's BUSINESS VALUATION ADVISOR

Welcome to TCA's **BUSINESS VALUATION ADVISOR**,  
a complimentary electronic newsletter for attorneys, advisors and planners to  
business owners and holding companies.

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## COMMENTARY

### Fair Market Value (As A Concept)

Welcome to the first edition of TCA's **BUSINESS VALUATION ADVISOR**. This newsletter is for the information of attorneys, financial planners and business owners who need to know about business valuation issues and current thinking in business appraisal. It is not a "how to" publication, but more of an explanation of a somewhat complicated and at times a convoluted professional service.

First of all, let's get something straight about business appraisal – Fair Market Value (FMV) is not the price at which an individual business owner *would* sell his business, it is the hypothetical definition of price used in our civil and tax courts to provide an equitable framework for the value of a business.

**Fair Market Value is . . . the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.**

*American Society of Appraisers in conformity with the U.S. Tax Code and  
IRS Revenue Ruling 59-60.*

From this seemingly simple definition of FMV, an entire industry has matured in the past 25 years to provide expert business valuation opinions. These opinions of value are tested in the court system everyday, where the IRS may dispute an expert's findings to divorce courts to minority shareholder disputes. Whole books and learned theses have been written on FMV concepts. Here at BVA, we will examine FMV concepts in the context of specific companies in unique situations. But, mostly we will inform you of what FMV is not, for when the blind wise men examined the elephant they could only tell you about the small part of the beast they examined. To wit-

FMV is not *fair* to one side or the other, depending on which side of litigation you happen to

be on. It also has nothing to do with the *market* (only comparatively), since the stock has never been sold. It is also not the *average* of two valuations or the *middle value* of some range. FMV is Revenue Ruling 59-60 applied to a specific set of facts by trained valuation analysts, using all of the information at their disposal, and a set of valuation principles in which both sides have agreed, to arrive at an equitable value to suit the particular situation. ■ - *Editor*

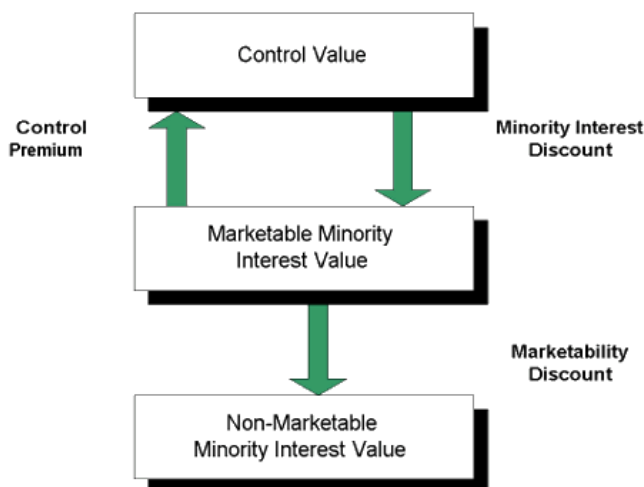
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## VALUATION PERSPECTIVES

### Discounts for Minority Interests and Lack of Control

The key principal tax advantage of gifting or transferring shares of privately held companies or asset holdings companies is the valuation discount. Significant to huge tax savings can be made on the transferred interests through the use of a business valuation and the determination of appropriate discounts. Recognized valuation methodology provides for two main discounts: lack of control and lack of marketability.

#### The Levels of Value



*Source: Mercer Capital et al.*

Business appraisers are extremely familiar with this chart (you might say it is indelibly etched in their brains). But for those who need to know about discounts the chart becomes simplicity itself. There are three traditional levels of value as follows:

1. Control Value. The value of the enterprise as a whole, also known as Enterprise Value.
2. Marketable Minority Interest Value. The value of minority interests that are freely tradable, but have none of the elements of control.
3. Non-marketable Minority Interest Value. The value of a minority interest without control and without liquidity (market).

For the discussion of minority interest discounts we will deal only with the top two levels: control value and minority interest value. The difference between control values and those lacking control (minority interests usually) is the rights associated with the ownership position. These rights have considerable value. Consider the owner of a 51% control interest and the owner of a 2% minority interest. The 51% owner has all of the following rights:

1. Appoint management.
2. Determine management compensation and perquisites.
3. Set policy and change the course of the business.
4. Acquire or liquidate assets.
5. Select people with whom to do business and award contracts.
6. Make acquisitions.
7. Liquidate, dissolve, sell out, or recapitalize the company.
8. Sell or acquire Treasury shares.
9. Register the company's stock for a public offering.
10. Declare and pay dividends.
11. Change the articles of incorporation or bylaws.
12. Block any of the above actions.\*

The minority shareholder lacks control and therefore his shares are worth less than the majority shareholder. The difference in value is called the control premium or the minority interest discount. How do you calculate the difference in value?

Suppose you own 100 shares of a publicly traded company and its shares sell for \$48. You would be said to have a marketable (publicly traded) minority interest (you only own .00185% of the company). Next week the company is sold to BIGCO for \$60 per share. In this scenario the value becomes a control marketable value since 100% of the stock has been sold. The difference between \$48 and \$60 is \$12. The difference is called either a 25% control premium (25% more than \$48) or a 20% minority interest discount (20% less than \$60). How do we apply this principal to closely-held and asset holding companies?

The answers are found in the marketplace. Generally, valuation analysts use empirical studies of mergers and acquisitions of publicly traded stocks. Some of the better known studies are the Mergerstat Review and HLHZ Control Premium Studies. For asset holding companies like FLPs and LLCs, valuation analysts must look at current market data as found in REITs, Limited Partnerships and closed end mutual funds. It is important to note that discounts and premia change with the market and the particular security to be valued. Very generally speaking, minority interest discounts can range from 10% to 40% and care must be taken in each case to back up the discount opinion with market based data. ■

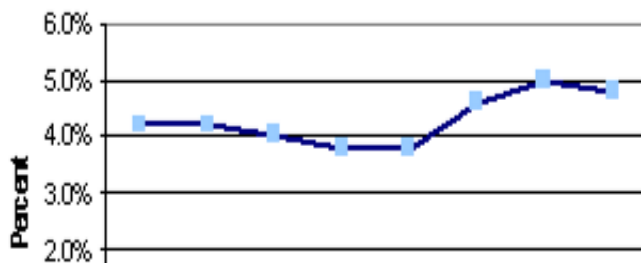
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\*Shannon P. Pratt et al., *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (3<sup>rd</sup> Edition 1996).

## MARKET WATCH

### 7520 Interest Rates

Recently 7520 interest rates have begun to creep up from their historic lows of 2003 (3.00%). They are currently at 4.8%. It would be an excellent time to consider a Grantor Retained Annuity Trust if you have not already done so. A target return for stocks might be 9%, thus setting the



stage for a very large amount of wealth to pass as a tax-free gift. ■

## FREQUENTLY ASKED QUESTIONS

***Q: My company is in an industry where the publicly traded companies are trading for 12 times earnings. What should the value of my company be?***

**A:** Most privately-held companies have an enterprise value determined by a multiple of pre-tax earnings. The “12 times earnings” in your question is an after tax Price/Earnings ratio. Multiply by 60% to convert to a pre-tax multiple of 7.2X. Most privately held companies will be worth considerably less due to size, capitalization, depth of management and other factors.

***Q: I am considering putting two pieces of commercial rental property into a FLP. What discounts can I expect?***

**A:** From a current real estate appraisal, discounts on fractional limited partnership interests (both minority and marketability discounts) might range from a low of 25% to as much as 45% or more, dependent upon how you and your attorney have structured the FLP.

***Q: I expect to sell my company in three years. The proceeds will likely be about \$10 million. What should I be doing now in preparation for the sale?***

**A:** In three parts – 1) financial planning, 2) estate planning and 3) see me. ■

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