DISCOUNT FOR LACK OF MARKETABILITY (DLOM)

When valuing an entity, it is often appropriate to subtract a Discount for Lack of Marketability (DLOM) in certain circumstances. This is an amount that comes right off the top of the value of the entity. For instance, a 15% DLOM essentially reduces the otherwise determined value of the entity by 15%. Thus, an entity with a value calculated to be worth one million dollars, would have a value of only $850,000 after the DLOM is applied (assuming there are no other Discounts or Premiums applied). The $850,000 amount would then become the amount used for determining equitable distribution if the valuation is for matrimonial purposes, or the amount used for determining Estate taxes if the valuation if for Estate tax purposes. Thus, obviously higher DLOMs result in lower amounts available for equitable distribution in matrimonial cases and lower taxes when the valuation is for Estate tax purposes. Thus, the appropriate percentage to use for a DLOM is often an issue of dispute between expert valuators on the respective sides.

The definition of a DLOM was addressed by the U.S. Tax Court in Furman v Commissioner of Internal Revenue, T.C. Memo 1998-157 (1998). The Court pointed out that a lack of marketability discount reflects the fact that there is no ready market for shares in a closely held corporation. Some of the relevant factors to be utilized in ascertaining the appropriate amount of the DLOM are as follows:

1. The cost of a similar entity's stock
2. An analysis of the entity's financial statements
3. The entity's dividend-paying capacity and dividend payment history

4. The nature of the corporation, its history, its industry position and its economic outlook

5. The entity's management

6. The degree of control to be transferred with the equity interest being valued

7. Restrictions on transferability

8. The period of time for which an investor must hold the equity interest to realize a sufficient return

9. The cost and likelihood of a public offering of the equity interest being valued

On September 25, 2009 the IRS published a comprehensive 116 page Job Aid that is titled "Discount for Lack of Marketability Job Aid for IRS Valuation Professionals." One of the issues examined in the IRS Published Aid on DLOM is the impact of Restricted Stock Studies in determining the appropriate percentage to use for a DLOM. This is because in determining the appropriate DLOM to apply, valuators sometimes consider the impact of Restricted Stock Studies. The average discounts in the Restricted Stock Studies as presented in the IRS DLOM Aid for those Studies that covered years prior to 1988 were typically above 30%. They then trended quite substantially downward starting in the 1990s. In certain cases, the U.S. Tax Court has relied upon the results of Restricted Stock Studies for purposes of ascertaining the appropriate Discount for Lack of Marketability, and in other cases the Court has criticized excess reliance upon them. To the extent the Restricted Stock Studies may be relied upon, it is my opinion that the studies utilizing periods prior to 1988 should probably receive minimal weight because they are too distant in time. This viewpoint typically results in determining an appropriate DLOM that is lower in today's valuation world, than discounts that may have

been applied in earlier years. It is certainly clear from the IRS Published Aid that the more recent Restricted Stock Studies indicate the appropriate DLOM should be lower. It should also be noted and emphasized that since higher DLOMs result in lower entity values, they are a targeted area for the IRS. In fact, there is substantial discussion in the valuation field currently, that the IRS wants to eliminate the DLOM entirely, although that has not yet occurred. Accordingly, in my view, valuators should tend towards conservatism in applying a reasonable DLOM.