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THE VALUATION OF CONTROLLING OWNERSHIP INTERESTS IN THE CONTEXT OF GIFT TAX PLANNING

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The increase in the federal lifetime gift and estate tax exemption amount that resulted from the Tax Cuts and Jobs Act of 2017 provides for unique wealth planning opportunities. Many of these opportunities involve the transfer of noncontrolling and controlling ownership interests in privately held operating business entities. The valuation of a controlling ownership interest in a business entity for transfer tax purposes may involve the application of a control premium. The selection and application of a control premium can have a significant effect on the concluded value of the transferred business interest. This article discusses the application of a control premium in the valuation process and the guidance that is available to assist the valuation analyst in properly quantifying the control premium.

Introduction

The Tax Cuts and Jobs Act of 2017 ("TCJA") created a unique opportunity to transfer wealth to the next generation in a tax-efficient manner. More specifically, the TCJA significantly increased the federal lifetime gift and estate tax exemption amount from the $5.49 million limit that was in effect prior to the passage of the TCJA. The exemption amount in 2024, which is indexed for inflation, is $13.61 million per person or $27.22 million for a married couple. However, that increased exemption amount is not permanent, and unless there are legislative changes, it will expire on December 31, 2025. After expiration, the exemption amount would decrease to $5 million, adjusted for inflation.

The current uncertainty concerning the law presents a unique opportunity for individuals to make significant gifts of wealth to younger generations. These gifts are often in the form of noncontrolling ownership interests in business entities, such as corporations, limited liability companies, and partnerships. However, it is not uncommon for a valuation analyst to encounter a transfer of a controlling ownership interest. In this case, the controlling business interest may need to be valued for transfer tax purposes.

In some circumstances, the value differential between a controlling ownership interest and a noncontrolling ownership interest in the same business entity may be substantial, particularly in the context of an operating entity.[1] However, in certain instances, the value differential may not be as large as once thought.

The application of a control premium accounts for most of the difference in value between a noncontrolling ownership interest and a controlling ownership interest. As a result, it is important that the valuation analyst understand the concept of a control premium and properly quantify and apply the premium, if necessary, in the valuation process.

Several common datasets are used for quantifying a control premium in the context of a business valuation. One of the most used datasets includes transaction data on stock price premiums paid to acquire controlling interests in publicly traded companies. In addition to empirical data on the premium for control, there is professional guidance on what an analyst may consider when quantifying a control premium.

THE SELECTED CONTROL PREMIUM IS INTENDED TO CAPTURE THE INCREMENTAL VALUE ASSOCIATED WITH OWNING A CONTROLLING INTEREST IN AN ENTITY.

For example, the Appraisal Foundation[2] issued guidance on the factors valuation analysts should consider when measuring and applying control premiums in the valuation process. The guidance was developed specifically for measuring the fair value of controlling interests in business enterprises for financial reporting purposes.[3]

However, many valuation analysts concluded that the guidance is equally relevant for the valuation of controlling business interests prepared for gift (and estate) tax purposes. And an increasing number of analysts rely on the guidance to ensure that they do not inadvertently overvalue controlling business interests for transfer tax purposes.

The guidance also may be useful to users of valuation reports. Users—who typically include estate planners, tax return preparers, and other professionals—may consider the guidance from the Appraisal Foundation in assessing whether a valuation report provides sufficient support and rationale for the application of a control premium.

Overview of the Guidance

A control premium may be applied when valuing a controlling ownership interest in a business entity. Although there are notable variations among valuation analysts in how control premiums are measured and applied when estimating value, many analysts follow the same procedure when converting a noncontrolling interest value to a controlling interest value. First, valuation analysts typically estimate the noncontrolling value of a business interest using data from guideline publicly traded companies and/or a discounted cash flow method. Second, in converting the indicated value from a noncontrolling interest basis to a controlling interest basis, the valuation analyst typically applies a control premium to the noncontrolling value.

The selected control premium is intended to capture the incremental value associated with owning a controlling interest in an entity. However, in many cases, the selected control premium is not the result of rigorous analysis. Instead, the premium is based, in large part, on premiums paid in the acquisition of controlling stakes in other "peer group" companies. In most cases, the peer group companies are significantly different from the subject company, and, as a result, the control premium data developed from the peer group companies are not necessarily applicable to a controlling interest in the subject company. In addition, that transaction pricing data may include consideration over and above an isolated control premium, such as consideration for postmerger synergies, which could result in an overestimate of the control premium applied to a subject company.

In many instances, the valuation analyst may gather control premium data from public company acquisitions and then blindly apply the data to the subject privately held company. This method of developing a controlling value for a business interest usually results in an unreliably high estimate of fair market value.

To address deficiencies in the valuation process and develop best practices around control premiums, the Appraisal Foundation issued *Valuations in Financial Reporting Valuation Advisory #3: The Measurement and Application of Market Participant Acquisition Premiums* ("Advisory #3"). Advisory #3 is intended to set forth best

A controlling interest in a business entity is not necessarily valued at a premium to a noncontrolling interest.

practices for certain issues that a valuation analyst may encounter in measuring the value of controlling interests in business enterprises.

Advisory #3 addresses the concept that the premium a hypothetical buyer may pay over the noncontrolling value of a business entity does not necessarily represent a premium for merely acquiring control. Instead, the premium reflects the expected increase in value that may be achieved by *exercising* control. In other words, an acquisition price that is higher than an entity's noncontrolling value may be reasonable if the hypothetical acquirer expects to increase the cash flow, increase the growth, and/or reduce the risk of the target entity. In contrast, if no such increases or risk reductions can be made, the hypothetical buyer generally would be reluctant to pay an acquisition price higher than the target entity's noncontrolling value. In such an instance, the noncontrolling value may be a reasonable estimate of the entity's controlling interest value.

Advisory #3 introduces the concept of a market participant acquisition premium ("MPAP") to distinguish the "premium" used in financial reporting valuations from the more commonly known "control premium" that often is used in valuations for transfer tax and other purposes. For purposes of this article, we use the more commonly accepted term of "control premium" when describing the guidance contained in Advisory #3.

Advisory #3 was developed to measure fair value for financial reporting purposes, but valuation analysts agree that the concepts described in Advisory #3 are applicable to valuations prepared for other purposes as well. This would include valuations of controlling business interests that are prepared for transfer tax purposes.

Defining the Premium

Advisory #3 defines the MPAP (i.e., the control premium) as the difference between (1) the pro rata fair value of the subject controlling business interest and (2) its "foundation." For purposes of this definition, a business's foundation is measured with respect to the current stewardship (i.e., management) of the business enterprise. More specifically, the foundation contemplates that the prerogatives of control will continue to reside with the existing controlling shareholder or group of shareholders.[4] For purposes of Advisory #3, the foundation is considered to be the pro rata value of a marketable, noncontrolling ownership interest in a business enterprise.

To further explain the concept of a control premium and its foundation (i.e., a marketable, noncontrolling value), consider a business enterprise with a founder who owns and controls 90 percent of the equity. Also, consider that ownership of the remaining 10 percent of the equity is fragmented, with no single shareholder holding more than 2 percent of the stock. The subject entity has several available investment opportunities that would enhance the company's value, but the controlling shareholder has chosen not to make any of these investments.

Given this set of conditions, a control premium likely would be applied in the valuation of the founder's controlling ownership interest in the entity. In other words, the price that may be paid by a hypothetical buyer for the founder's controlling ownership interest in the company is likely to exceed the price that may be paid for a noncontrolling ownership interest that reflects the current stewardship of the company (i.e., the foundation). According to Advisory #3, the magnitude of the control premium would be influenced by the perceived ability of market participants (i.e., hypothetical buyers) to exercise the prerogatives of control to increase the cash flow and/or reduce the cost of capital applicable to the subject controlling ownership interest.[5]

In general, the guidance recommends that a control premium should be supported by reference to (1) enhanced cash flow and/or (2) a lower required rate of return from the perspective of a hypothetical buyer of the controlling business interest. In instances where no such opportunities exist for a hypothetical buyer, the guidance concludes that the control premium is minimal or nonexistent.

Quantifying the Control Premium

A holder of a controlling business interest may possess several prerogatives of control. However, these prerogatives, such as (1) the right to appoint a majority of the board of directors, (2) the right to recapitalize the company, or (3) the right to select suppliers and vendors, have only limited inherent value in and of themselves. In other words, these commonly cited rights are merely a means through which a hypothetical buyer may be able to generate incremental economic benefits.

For example, the right of a controlling shareholder to elect a majority of the board of directors does not necessarily convey any economic benefit to a hypothetical buyer, unless the ability to elect a majority of the board enables the company to increase its revenue and/or lower its costs. In this case, the expected economic benefit could affect the price that would be paid by a hypothetical buyer and, potentially, influence the magnitude of the control premium.

The concepts addressed in Advisory #3 recommend that a control premium should be supported largely by expected economic benefits that would arise from (1) enhanced cash flow and/or (2) lower required rates of return from a hypothetical buyer's perspective. In this regard, the valuation analyst is tasked with identifying the economic benefits that reasonably would be available to a hypothetical buyer of the controlling ownership interest.

If no such potential economic benefits can be identified, a strong case can be made that a hypothetical buyer would not be inclined to pay a control premium for the subject controlling business interest.

In terms of economic benefits that arise from enhanced cash flow, the guidance notes several areas where a hypothetical buyer may implement strategies that lead to increased cash flow. These areas include, but are not limited to, the following:

- Increased company revenue growth
- Increased company operating margins
- Working capital efficiencies
- Capital expenditures efficiencies

Regardless of how increased revenue or decreased costs are achieved, it is important to recognize that to be relevant in estimating the control premium, the enhanced cash flow must be incremental to the cash flow that was expected under current company stewardship. Stated another way, enhanced cash flow that gives rise to a control premium is incremental to the prospective financial performance that reflects the ongoing operations of the business enterprise without a change-of-control transaction.[6]

In terms of economic benefits that arise from a lower required rate of return, the guidance notes several reasons why hypothetical buyers may have a lower required rate of return for a controlling ownership interest than for an otherwise identical, but noncontrolling, ownership interest under current company stewardship. Some of these reasons include, but are not limited to, the following:

- Change in capital structure
- Economies realized through increased company size
- Reduced operating risk

In summary, the guidance advocates the use of a control premium when valuing a controlling ownership interest in a business enterprise, but only in situations where the hypothetical buyer of the controlling ownership interest can implement changes that would cause an increase in the entity's cash flow and/or a reduction in the equity holders' required rate of return.

Example of a Control Premium in the Transfer Tax Setting

The concepts described in Advisory #3, while simple to understand, can have a large effect on the valuation of controlling business interests. Consider an example that illustrates how the guidance described in Advisory #3 can affect the valuation of a controlling ownership interest for gift tax purposes.

Consider a taxpayer who intends to transfer—via gift—100 percent of the equity of Beta Company. Also, consider that Beta Company is operated efficiently and is an industry leader. The business has a competent management team that understands how to maximize revenue and properly manage costs. The company is well financed and has access to additional sources of equity and debt capital, if needed, at competitive rates. Finally, consider that a valuation analyst uses a guideline publicly traded company method and a discounted cash flow method to arrive at a noncontrolling value for the Beta Company equity, and both methods support a value of $100 million.

The right of a controlling shareholder to elect a majority of a board of directors does not necessarily convey any economic benefit, unless that right enables the company to increase its revenue and/or lower its costs.

In the past, many analysts mistakenly would assume that the value derived from the guideline publicly traded company method necessarily results in a noncontrolling value simply because the public company market pricing data that were used to estimate the value were based on transactions of noncontrolling interests in publicly traded stock.[7] Many analysts also mistakenly would assume that the discounted cash flow method necessarily results in a noncontrolling interest value. As a result, the valuation analyst would be inclined to apply a control premium to the value indicated by both methods.

Now consider that the valuation analyst quantified a control premium based on change-of-control transactions involving companies that operate in the same industry as the subject company. Also, assume these transactions indicated that buyers paid, on average, a premium for control of 20 percent of the noncontrolling value of the target companies. Applying the selected control premium of 20 percent to the noncontrolling value of $100 million results in a controlling value of the Beta Company business equity of $120 million.

In the past, many valuation analysts would be confident in their conclusion that the subject ownership interest should be valued at $120 million because the selected control premium was based on observable market data. However, many of these analysts would not be able to explain why a hypothetical buyer of the subject equity interest would be willing to pay a $20 million premium simply to gain control of Beta Company. The inability of the valuation analyst to make that explanation may be the first indication that the subject equity interest is overvalued.

The analyst would have arrived at a much different value conclusion if the analyst followed the guidance in Advisory #3. More specifically, if the analyst focused on the potential changes that a hypothetical buyer of the subject ownership interest could implement rather than the price premiums paid in transactions involving peer group companies, the analyst would have concluded a much lower value for the subject ownership interest in Beta Company. Following the guidance, the analyst would have concluded that there were only limited opportunities for a change-of-control buyer to increase the revenue and/or decrease the expenses of the subject company. The analyst also would have concluded that Beta Company is adequately capitalized, with little opportunity to reduce the company's cost of capital.

Given these conditions, the framework of Advisory #3 would have led the analyst to conclude there is little, if any, control premium associated with the subject ownership interest. The result would have been a value conclusion that was at or near $100 million, rather than $120 million.

At first glance, it may appear unusual that a controlling ownership interest may have virtually the same value as a noncontrolling ownership interest in the same company. However, the guidance of Advisory #3 has caused more valuation analysts to become comfortable with the fundamental concept that a hypothetical buyer would pay a premium for a controlling interest only if control allowed the buyer to extract additional economic benefits from the company.

Reviewing a Valuation Report of a Controlling Ownership Interest

The concepts described in Advisory #3 also provide a framework that can assist estate planners and tax return preparers in their review of valuation reports that are attached to gift (and estate) tax returns. Using the guidance, we can develop a list of "red flags" that may indicate the valuation analyst unintentionally overvalued the subject controlling ownership interest. Identifying these potential points of inquiry can be a starting point for a dialog between the estate planner and the valuation analyst.

A nonexhaustive list of these red flags includes the following:

- Does the valuation analyst neglect to explain how the peer group companies that are used to develop a control premium are comparable with the company being valued?
- Does the valuation analyst apply a control premium without analyzing the potential for (1) revenue enhancement, (2) cost savings, and/or (3) decreases in the company's cost of capital that could be implemented by a hypothetical buyer of a controlling interest?
- Does the analyst mistakenly conclude that a control premium must be applied to a value indication simply because it was derived using the guideline publicly traded company method?
- Does the analyst mistakenly conclude that the discounted cash flow method resulted in a noncontrolling value for the subject business interest, so, as a result, a control premium must be applied?

Answering yes to any of these questions may indicate an overvaluation of the subject controlling business interest.

Having a working knowledge of Advisory #3 will help a valuation analyst avoid the pitfalls associated with misapplying a control premium and overvaluing a controlling business interest.

Also, having a general understanding of what drives the existence of a control premium will better equip an estate planner and tax preparer to provide meaningful feedback to the valuation analyst after a review of the valuation report.

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References:

1 For purposes of this article, an operating entity is defined as a corporation, limited liability company, or partnership that operates an active business. In contrast, a holding entity is typically a corporation, limited liability company, or partnership that passively holds investments.

2 The Appraisal Foundation is the U.S.'s foremost authority on the valuation profession. The organization sets the congressionally authorized stanards and qualifications for real estate appraisers and personal property appraisers and provides voluntary guidance on recognized valuation methods and techniques for all valuation professionals. The Appraisal Foundation also ensures that the profession adapts to changing circumstances and continues to move forward through the work of its two independent boards: the Appraiser Qualifications Board and the Appraisal Standards Board.

3 Valuations prepared for financial reporting purposes generally are valuations of assets, liabilities, and business interests that are used in the preparation of an entity's financial statements.

4 Advisory #3, 10.

5 Ibid., 11.

6 Ibid., 15.

7 In other words, noncontrolling transactions in the stock of publicly traded peer group companies are used to estimate valuation pricing multiples. These multiples are applied to the earnings and/or cash flow of the subject company. Since the pricing multiples of the peer group companies are based on trades of small, noncontrolling interests in the stock, many analysts have taken the long-standing position that the value that results from the application of these public company pricing multiples must be on a noncontrolling basis.