

Unit Valuation Insights

UNIT VALUATION DISCOUNT AND PREMIUM ADJUSTMENTS

Craig A. Jacobson

Valuation discount and premium adjustments are often applicable in ad valorem tax unit valuations, much as these adjustments are often applied in business enterprise valuations. There are two types of valuation discount and premium adjustments: (1) systematic (or level-of-value) adjustments and (2) unsystematic adjustments. This discussion focuses on both systematic and unsystematic adjustments. More importantly, this discussion presents a framework for estimating valuation discount and premium adjustments for ad valorem tax unit valuation purposes.

INTRODUCTION

Ad valorem tax unit valuations are conceptually and methodologically similar to taxpayer corporation business enterprise valuations. Of course, the objective of unit valuation methods is to estimate the value of the taxpayer corporation operating assets subject to ad valorem tax. The objective of the business enterprise valuation is to value the taxpayer corporation debt and equity securities.

In certain applications of the direct capitalization method and the stock and debt method, valuation analysts value the subject taxpayer corporation operating assets by the direct reference to the publicly traded securities of selected comparable companies. These publicly traded companies are selected because the valuation analyst concludes that they are sufficiently comparable to the subject taxpayer corporation.

However, the taxpayer corporation is often not perfectly comparable to these selected publicly traded companies. And, the taxpayer corporation unit of operating assets is often not comparable to the publicly traded securities of the selected public corporations.

When the selected valuation benchmarks are not sufficiently comparable to the appraisal subject (i.e., the taxpayer corporation unit of operating assets), then the valuation analyst should consider the application of a different valuation approach or method. However, when the comparability differences between the selected valuation benchmarks and the appraisal subject can be both identified and quantified, then the valuation analyst may be able to account for these comparability differences through the use of valuation adjustments—that is, valuation discounts and premiums.

This discussion summarizes the use of valuation adjustments in the unit valuation of taxpayer corporation operating assets for ad valorem tax purposes.

Valuation adjustments are commonly used in many business enterprise valuation analyses. Valuation adjustments are commonly applied in business enterprise valuations performed for the following purposes:

- transaction pricing and structuring
- financing collateralization and securitization
- federal income, gift, and estate tax planning and compliance
- bankruptcy and reorganization
- financial accounting and public reporting
- litigation support and dispute resolution
- management information and corporate governance

Valuation adjustments can be either discounts or premiums. There are “level-of-value” adjustments that are routinely considered in many valuation analyses. This type of valuation adjustment includes adjustments reflecting:

1. the degree of ownership control or lack of ownership control and
2. the degree of marketability or lack of marketability of the subject ownership interest.

The consideration of this type of valuation adjustments is a common analytical procedure in business enterprise valuations and certain property valuations—for example, in the valuation of less than a fee simple ownership interest. This is because the different valuation approaches and methods typically conclude different levels of value.

These valuation adjustments are called systematic adjustments. This is because they apply across different industries and across different company types and sizes.

The application of systematic valuation adjustments is typically influenced by:

1. the legal and economic characteristics of the subject business or property (e.g., whether the appraisal subject represents operational or ownership control of the taxpayer corporation);
2. the selected standard of value (e.g., fair market value, fair value, or investment value); and
3. the selected premise of value (i.e., what premise of value represents the highest and best use of the subject operating assets?).

This discussion summarizes these systematic (or level-of-value) adjustments in order to contrast them with nonsystematic valuation adjustments. As the name implies, nonsystematic adjustments do not apply across the board to all property interests of the same level of value. While nonsystematic adjustments should be considered in all unit valuations, these adjustments are often not applied.

Nonsystematic valuation adjustments typically fall into four categories:

1. taxpayer-corporation-specific adjustments,
2. property-specific adjustments,
3. contract-imposed adjustments, and
4. multitier adjustments.

These adjustments relate to some factors that are specific to the subject unit valuation (i.e., the particular taxpayer corporation operating assets that would cause the valuation analyst to apply a valuation discount or premium).

GENERAL CAVEATS

In any discussion of valuation adjustments, several general caveats are in order. First, both systematic and nonsystematic adjustments are always made to reach a value conclusion. Adjustments are not made from a value conclusion. Inexperienced valuation analysts are often confused by this important distinction.

Inexperienced valuation analysts believe that an analyst first reaches a correct value conclusion for the subject taxpayer unit. Then, the valuation analyst applies a discount or premium to the concluded unit value in order to arrive at a discounted value or an inflated value.

This misconception is both procedurally and conceptually incorrect. In fact, the valuation analyst applies valuation methods to conclude preliminary value indications. Each unit valuation method involves numerous analytical procedures. The various unit valuation methods provide preliminary value indications—until all of the requisite procedures are performed.

One of the requisite procedures in all unit valuation methods is to consider (and apply, when appropriate) valuation discounts and premiums. So, valuation adjustments are applied to preliminary value indications to arrive at a final value conclusion. Valuation adjustments are not applied to a final value conclusion to arrive at a discounted or inflated value conclusion.

Second, the application of both systematic and nonsystematic adjustments—and the magnitude of any adjustments—may vary for each unit valuation approach and method. There are two components to this caveat: (1) implicit level-of-value, systematic adjustments and (2) implicit/explicit quantification of nonsystematic adjustments.

Some unit valuation approaches and methods typically conclude a certain level of value. Typically, the sales comparison approach/guideline publicly traded company method concludes a marketable, noncontrolling-ownership-interest level of value. Typically, the cost approach/replacement cost new less depreciation method concludes a marketable, controlling-ownership-interest level of value.

Typically, the income approach/yield capitalization method concludes either a controlling or a noncontrolling ownership interest level of value. That is, the concluded level of value depends on the individual valuation variables selected for both (1) the economic income projection and (2) the present value discount rate.

In each of these instances, the application of a systematic level of value adjustment depends on both (1) the level of value typically concluded by the selected unit valuation method and (2) the individual valuation variables used in the specific analysis of that method.

Therefore, within the same unit valuation assignment, systematic adjustments may apply to some unit valuation methods and not to others. Depending on the individual variables used within the valuation method, different magnitudes of the same valuation adjustment (e.g., discount for lack of marketability) may apply among the different unit valuation methods used in the overall analysis.

Regarding nonsystematic adjustments, the valuation analyst sometimes makes an implicit adjustment within an individual unit valuation method analysis. The valuation analyst may also apply an explicit adjustment to the value indication concluded by the individual, unit valuation method.

For example, let's consider a discount for key person dependence. The key person could be the taxpayer corporation chief executive officer, chief salesperson, chief design engineer, or any other senior—and strategically important—executive. If the valuation analyst uses the income approach/yield capitalization method, the analyst could quantify a key person dependence discount either implicitly or explicitly.

Implicitly, the valuation analyst could adjust the economic income projection for the cost to recruit, hire, train, and maintain a hypothetical replacement executive (e.g., a first lieutenant for the key executive). Explicitly, the valuation analyst could conclude an unaffected preliminary taxpayer unit value indication—and then subtract either a discrete percentage discount or a discrete dollar discount (for key person dependence) from the preliminary figure.

Third, the application of both systematic and nonsystematic adjustments is directly affected by the standard (or definition) of value sought in the unit valuation assignment. If the standard of value is fair market value, then most valuation adjustments will typically be considered. This is because the marketplace of willing buyers and willing sellers will generally recognize all valuation discounts and premiums.

However, if the appropriate standard of value is other than fair market value, certain systematic, level-of-value adjustments may not apply. For example, in an investment value assignment, the valuation analyst may not apply a nonsystematic discount for a suboptimal product distribution function at the subject taxpayer corporation. If the current corporate owner wants to quantify the value to itself (given its specific corporate investment criteria) of a certain subsidiary, then a discount for the lack of a distribution function may not be relevant.

Let's assume that the corporate parent is a company like Procter & Gamble (i.e., a company recognized for its world class product distribution function). Let's assume also that the current corporate parent manages the subject taxpayer corporation as a manufacturing subsidiary that effectively sells to a market distribution subsidiary.

For such an investment value analysis, the lack of the subject company's distribution system would not represent a value penalty to the current owner. Therefore, the valuation analyst may not apply a nonsystematic lack of distribution function discount in an investment value analysis for a Procter & Gamble-like corporate owner.

NONSYSTEMATIC VALUATION ADJUSTMENTS

Something that is nonsystematic is not orderly, regular, or consistent. Nonsystematic valuation adjustments are discounts or premiums that may be considered—but are typically not applied—in all unit valuations. Rather, they are specific to the individual facts and circumstances of the particular subject taxpayer or taxpayer corporation operating assets.

Nonsystematic valuation adjustments generally are grouped into the following four categories: (1) taxpayer-corporation-specific, (2) property-specific, (3) contract-specific, and (4) multitier. Each of the four categories of nonsystematic valuation adjustments is discussed below.

Taxpayer-Corporation-Specific Adjustments

Taxpayer-corporation-specific valuation adjustments relate to facts and circumstances specific to the subject taxpayer. Common examples of taxpayer-corporation-specific adjustments include discounts for:

- key person dependence
- key customer dependence
- key supplier dependence
- key product or technology dependence
- suboptimal capital structure
- suboptimal cost of capital

These factors can be either controllable or noncontrollable. The subject taxpayer corporation management may decide to employ a 100 percent equity capital structure because of its aversion to financial risk. That is a controllable decision.

On the other hand, there may be only one domestic supplier for the taxpayer corporation's key production component. In that case, management's reliance on the key supplier is an example of an uncontrollable decision.

In any event, all of these factors first affect the valuation at the unit or business enterprise level. These factors are not related to the level of value of the subject operating asset ownership interest. They also typically do not affect one class of operating assets differently from another class of operating assets.

Each of the factors in this category makes the subject taxpayer corporation different (from an investment risk and expected return perspective) from the typical company in the subject industry or peer group. Accordingly, this category of valuation adjustment is generally made at the taxpayer corporation (total unit or total invested capital) level.

Property-Specific Adjustments

Property-specific valuation adjustments relate to facts and circumstances specific to the subject category of property or operating assets. Common examples of property-specific valuation adjustments include:

- discount for regulatory influence
- discount for environmental risks
- discount for inability to respond to changes in market dynamics

All of these factors first affect the valuation at the level of either the category of property type or the specific subject operating assets. Each of the factors in this category

makes the appraisal subject different (from an investment risk and expected return perspective) from the selected comparable company securities used for valuation pricing purposes.

In any event, this category of valuation adjustment is generally applied at the subject property level and not at the taxpayer corporation level.

Contract-Specific Adjustments

Contract-specific valuation adjustments relate to facts and circumstances imposed on the subject unit by the influences of a contract, agreement, regulation, or covenant. Common examples of contract-specific valuation adjustments include:

- franchise agreements
- certificates of need
- permits and licenses
- zoning and property use restrictions

All of these factors affect the valuation of the subject ownership interest as an exogenous influence. That exogenous influence is often the result of a particular unit of assets being subject to the terms and conditions of some type of contract or agreement. This is often the case with public utility units, government regulated taxpayers, or other types of centrally assessed taxpayers.

Each of the factors in this category makes the subject unit of operating assets different (from an investment risk or expected return perspective) from the securities of the selected comparable companies that are not subject to the contractual or regulatory influence, that is, different from the comparable company security used for valuation pricing purposes. In any event, this category of valuation adjustment is typically applied at the subject operating asset level.

Multitier Adjustments

Multitier valuation adjustments relate to facts and circumstances specific to the ownership structure of the subject operating asset. Common examples of multitier valuation adjustments include:

- operating assets owned by multiple tiers of corporate ownership
- any multitier ownership in which a sale of operating assets will trigger recognition of taxable capital gains
- a fractional or partial property ownership interest

Multitier valuation adjustments are sometimes referred to as inside/outside valuation adjustments. In the typical

instance, asset A is owned by asset B, which may itself be owned by asset C, the valuation subject. Typically, in order to receive income distributions, the owner of asset C must first liquidate assets A and B. Accordingly, there is a series of property-specific and contract-specific adjustments that should be applied.

In the multitier ownership unit valuation, the question arises not only as to the magnitude of the appropriate valuation adjustments, but also as to the sequencing (and relative magnitude) of valuation adjustments.

Typically, the lower level or “inside” adjustments are applied first, and the higher level or “outside” adjustments are applied second. That is, adjustments are applied to asset A, and an asset A cash equivalency value is estimated. Then, adjustments are applied to asset B, and an asset B cash equivalency value is estimated. Finally, adjustments are applied to asset C, and an asset C value is concluded.

SYSTEMATIC VALUATION ADJUSTMENTS

Systematic events affect a broad population and occur with regularity and order. In contrast to nonsystematic adjustments, systematic valuation adjustments affect a broad range of valuation assignments.

The valuation analyst’s application of systematic valuation adjustments occurs with greater regularity. In fact, depending on the unit valuation methods used, virtually all business enterprise and unit valuations involve either implicit or explicit systematic valuation adjustments. Accordingly, the valuation analyst should consider the appropriateness of systematic adjustments in virtually every unit valuation.

Although the category of systematic adjustments is not limited to level-of-value adjustments, level-of-value adjustments are the most common type of systematic adjustments. There are two reasons for this. First, virtually every unit valuation assignment involves a specified level of value. Second, alternative unit valuation methods typically conclude value indications at different levels of value.

Therefore, if the subject analysis involves two or more unit valuation methods, the valuation analyst will typically have to apply some systematic adjustment in order to conform all of the value indications to the same level of value. All value indications should be stated on the same level of value (typically, the level of value consistent with the unit valuation assignment) before a meaningful valuation synthesis and conclusion is reached.

The most common systematic valuation adjustments include the following:

- discount for lack of marketability (related to any operating assets that are less liquid than publicly traded securities—when such securities are used as a valuation benchmark)

- discount for lack of absolute ownership control (e.g., related to the level of control of the subject operating assets) or operational control (e.g., related to assets that operate in a highly regulated industry)

These adjustments relate to the level of value of the subject ownership interest. Many inexperienced valuation analysts believe that there are only three or four discrete levels of value. In fact, there is a virtually continuous spectrum of levels of value. The level of value spectrum itself has two axes: (1) ownership control elements and (2) marketability elements.

There is a broad spectrum of value influences ranging from absolute ownership or operational control with immediate synergistic opportunities, to absolute lack of ownership or operational control.

There is also a broad continuing spectrum of value influences with regard to property marketability elements. This

spectrum of value influences ranges from absolute liquidity (equivalent to that enjoyed by actively traded stock listed on a public stock exchange) to virtually absolute illiquidity (imposed by an FLP, stockholder, buy/sell agreement, or by another contract or agreement that restricts transfers, limits potential buyers, or dictates sale price).

The multitier ownership structure of the subject operating assets (e.g., an asset owned by an asset that is owned by another asset) may also have marketability implications that influence the unit value.

While it may be impossible for valuation analysts to conceptualize all of the discrete steps along the control/marketability continuum, these two elements effectively represent a continuous spectrum of combined valuation adjustment possibilities.

However, for visualization and illustrative purposes only, Exhibit 1 represents several of the common levels of value with regard to unit valuation. Where applicable,

Exhibit 1
Unit Valuation Adjustments—
Simplified Illustration of Common Levels of Value

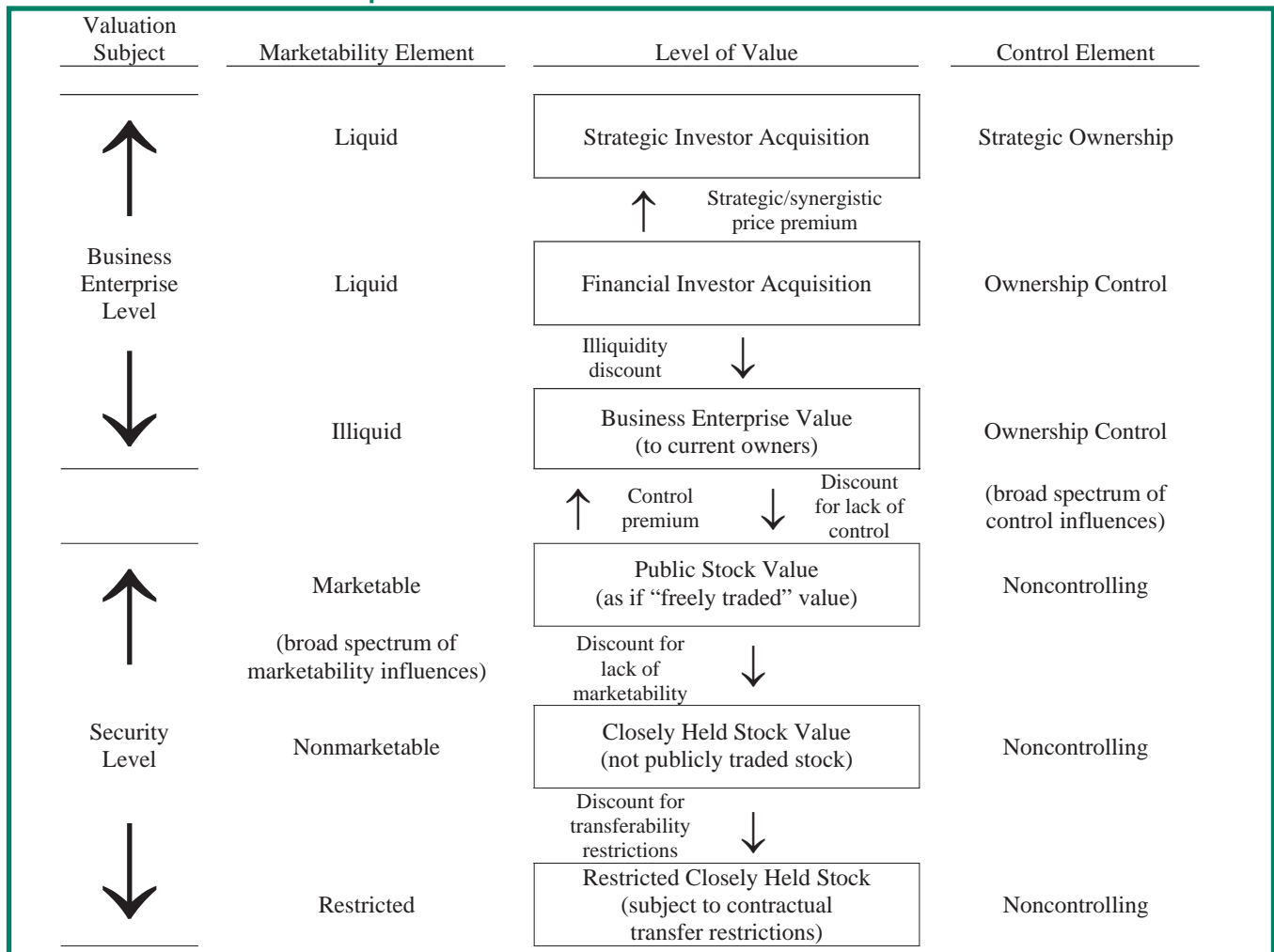


Exhibit 1 also presents simplified indications of the valuation discount or premium relationships among the common levels of value.

Nonsystematic valuation discounts and premiums may be quantified as either a percentage or a dollar amount. When both percentage and dollar amount adjustments are appropriate, the valuation analyst should carefully consider the appropriate sequence for applying the adjustments. However, systematic valuation discounts and premiums (particularly level-of-value adjustments) are typically quantified as percentage adjustments.

Therefore, if both control and marketability discounts and premiums are applied as percentage adjustments, the mathematical sequencing of the application of systematic adjustments is irrelevant. That is, as long as they are all expressed on a percentage discount or premiums basis, the systematic valuation adjustments can be applied in any order.

WHY VALUATION ADJUSTMENTS ARE INTEGRAL TO THE VALUATION PROCESS

The experienced valuation analyst understands that the concept of valuation adjustment is meaningless without a clear answer to the question: adjustment to what? The valuation analyst first has to understand the baseline or benchmark against which any valuation discount or premium is being contemplated. In other words, the application of any valuation discount or premium is fundamentally inappropriate unless the benchmark (against which the adjustment is compared) is clearly defined.

For example, it may be inappropriate to apply a discount for lack of marketability to a value indication that is already stated on a nonmarketable basis. Likewise, it may be inappropriate to apply an ownership control premium to a value indication that is already stated on a controlling ownership interest basis.

The first question for the valuation analyst to ask with regard to a valuation adjustment is: what do I have? This question relates to what systematic and nonsystematic elements exist in:

- the unit valuation approaches and methods selected,
- the individual valuation variables selected,
- the comparable company or other transactional data extracted, and
- the valuation method indications derived.

These elements (either present or absent) represent the baseline or benchmark of the unit valuation analysis.

The second question for the valuation analyst to ask with regard to a valuation adjustment is: what do I want?

This question relates to what systematic and nonsystematic elements exist in the subject taxpayer corporation or in the subject operating assets.

In particular, the valuation analyst is looking for operational, financial, contractual, and regulatory features of the subject taxpayer corporation or operating assets that are different from those of the benchmark analysis. These selected features might make the subject taxpayer corporation or operating assets different from the benchmark analysis from an investment risk or expected return perspective.

It is obvious why the valuation analyst should first thoroughly understand the benchmark analysis. At this point in the unit valuation, the benchmark analysis is what the valuation analyst has. Ideally, the benchmark analysis should perfectly match the subject taxpayer corporation or operating assets from an investment risk and expected return perspective. This is because an analysis of the subject taxpayer or operating assets is what the valuation analyst wants.

If the elements in the benchmark analysis match up perfectly with the elements in the subject taxpayer corporation or operating assets, then no valuation adjustment is needed. Of course, that is rarely the case.

Therefore, the third question for the valuation analyst to ask with regard to a unit valuation adjustment is: how is the subject taxpayer or operating assets different from the benchmark analysis? When answering this question, the valuation analyst identifies all of the systematic and nonsystematic elements in the subject unit that are not in the benchmark analysis—and vice versa.

Finally, the fourth question for the valuation analyst to ask with regard to a unit valuation adjustment is: how do I get to what I want from what I have? In other words, what valuation adjustments are needed to make the value indications and conclusions of the benchmark analysis more applicable to the unit valuation subject?

Alternatively, what valuation adjustments are needed to minimize the systematic and nonsystematic element differences between the benchmark analysis and the unit valuation subject?

This fourth question helps the valuation analyst identify the valuation adjustments that make the investment risk and expected return features of the benchmark analysis look more like the unit valuation subject. It is not the objective of valuation adjustments to make the investment risk and expected return features of the subject taxpayer corporation or operating assets look more like the benchmark analysis.

In summary, valuation adjustments are applicable only to make the benchmark or baseline analysis look more like the subject taxpayer corporation or subject operating assets from an investment risk or expected return perspective. Therefore, it is important that the valuation analyst fully understand the systematic and nonsystematic elements of

the benchmark analysis before any valuation adjustments are considered.

In addition, the selection of valuation adjustments is influenced by (1) the individual unit valuation approaches, methods, and procedures performed, and (2) the purpose and objectives of the ad valorem tax valuation, including the standard of value and the premise of value appropriate to the individual unit valuation.

Exhibit 2 presents a noncomprehensive listing of common unit valuation discounts and premiums. Exhibit 2 does not distinguish between systematic (or level-of-value) adjustments and nonsystematic adjustments.

While Exhibit 2 is not intended to be comprehensive, it does provide a convenient checklist or reminder list.

METHODS TO QUANTIFY VALUATION ADJUSTMENTS

There are numerous analytical procedures that may be used to quantify both systematic and nonsystematic valuation adjustments. When considered conceptually, all of these analytical procedures are grouped into four categories of methods:

1. comparative empirical data regarding the unit valuation subject.
2. comparative income data regarding the unit valuation subject.
3. published empirical data regarding valuation guidelines and benchmarks.
4. reliance on judicial and administrative guidance.

The first two of these methods use data extracted directly from the subject taxpayer corporation or operating assets. If such data are available, these methods provide valuation adjustment indications specifically derived from the subject unit.

In the first method, the valuation analyst compares the subject unit to a benchmark or baseline that does not have the discount or premium value influence. Based on this comparison, the valuation analyst extracts pricing metric data that are used to quantify the specific valuation adjustment.

In the second method, the valuation analyst compares some measure of the subject unit income to the same income measure, adjusted to exclude the effect of the valuation discount or premium. Capitalization of this income differential provides an indication of the appropriate amount of the valuation adjustment.

Exhibit 2 Business/Security Valuation Adjustments— List of Common Valuation Discounts and Premiums

Valuation Discounts Related to:

Assignee ownership interest
Blockage (size) of public stock
Built-in capital gains taxes
Call options
Founder/letter/legend stock
Illiquidity (at business enterprise level)
Key customer dependence
Key person dependence
Key supplier dependence
Key technology dependence
Lack of dividend rights
Lack of marketability (at security level)
Lack of ownership/operational control
Lack of preemptive rights
Lack of voting rights
Multitier ownership structure
Partial/fractional ownership interest
Right of first refusal
SEC Rule 144
Suboptimal capital structure
Suboptimal cost of capital
Transferability restrictions (contractual)
Unlisted stock of public company

Valuation Premiums Related to:

Ownership/operational control
Put options
Strategic/synergistic benefits
Superliquidation preference
Supervoting rights

Using the comparative empirical data method, the valuation analyst typically looks for comparative sales involving the subject operating assets, in which (1) one sale does not have the particular discount or premium feature and (2) the otherwise comparable sale does have the particular discount or premium feature.

Using the comparative income data method, the valuation analyst typically identifies revenue, expense, or investment differences that are attributable to the particular discount/premium feature. The valuation analyst attempts to quantify how the subject unit revenue, expenses, or investment would change if the particular discount or premium feature changes.

The valuation analyst then capitalizes the expected income change over the remaining useful life of the income change. The present value of the projected income difference provides an estimate of the amount of the valuation discount or premium.

All of the procedures related to the empirical data and the empirical income methods ultimately involve three types of analyses:

1. estimate of the income shortfall related to the valuation discount or the income excess related to the valuation premium
2. estimate of the cost to cure the deficiency feature
3. paired sales analysis of operating asset transactions with and without the subject discount or premium feature

The empirical data and empirical income methods rely on income, cost, or sales data extracted from the subject taxpayer corporation in order to quantify the systematic or nonsystematic valuation adjustment. The published empirical data method is the most commonly used method to quantify valuation discounts and premiums. Arguably, it is also the most commonly misused method.

Many valuation analysts rely on published studies of empirical data to derive level of value adjustments, such as a discount for lack of marketability or a premium for ownership control. There are also numerous published studies with regard to nonsystematic valuation adjustments as well, such as a discount for lack of voting rights.

Most published empirical studies rely on the paired sales analysis procedure. That is, the studies analyze one set of sale transactions that are not affected by the subject feature and one set of sale transactions that are affected by the subject feature. The percentage difference in transaction prices (or the percentage difference in transaction pricing multiples) provides an indication of the amount of the individual valuation discount or premium.

The difference in this third method (compared to the first two methods) is that both sides of the paired sales analysis comparison relate to comparable company or com-

parable asset transactions. In other words, none of the data analyzed in these published studies actually comes from the subject taxpayer corporation or operating assets.

However, this factor should not invalidate this method. The concern regarding the use of this valuation adjustment quantification method is not the data source. The concern is how the valuation analyst relies on the published study results in order to select subject-specific valuation adjustments.

Many valuation analysts rely on the more popular published empirical studies without understanding the procedural mechanics of the published study, understanding the type (e.g., industry, size, etc.) of transactions analyzed in the published study, or considering the time period of the study (compared to the subject valuation date).

In addition, many valuation analysts naively select the mean or median conclusion from the published study as the appropriate valuation discount or premium in every unit valuation. These valuation analysts often do not study the range of results indicated by published studies—such as the interquartile conclusions, the standard deviations, and the high/low observations.

These valuation analysts often do not consider (qualitatively or quantitatively) exactly what valuation adjustment would be appropriate to the unique factors of the subject taxpayer corporation or the subject operating assets—given the range of data reported in the published empirical study.

The fourth method for quantifying valuation adjustments relies on published judicial precedent and administrative rulings (e.g., Internal Revenue Service (IRS) audit settlement agreements) for guidance. While this method is sometimes used by inexperienced valuation analysts, it is not recommended by experienced valuation analysts.

This method does provide the analyst with very useful information as to the reasonable range of valuation discounts and premiums that courts and regulators have found acceptable. However, these data do not provide a particularly useful source of information from which to select a specific valuation adjustment related to an individual unit valuation.

Judicial precedent, IRS letter rulings and settlement agreements, and other administrative rulings are always fact-specific. By definition, they only apply to the specific facts and circumstances of the matter or taxpayer corporation involved. They are not intended to provide general professional guidance with regard to the appropriate level of valuation discounts and premiums.

Published judicial decisions (and other rulings) are only applicable to the extent that the subject taxpayer corporation or operating assets are identical to facts and circumstances of the published decision. That is hardly ever the case.

Exhibit 3 presents a nonexhaustive listing of ten caveats that valuation analysts should consider with regard to identification and quantification of unit valuation discounts and premiums. These “top ten” caveats apply to all four methods for quantifying valuation adjustments.

SUMMARY AND CONCLUSION

The proper consideration of valuation discount and premium adjustments is an essential step in ad valorem tax unit valuations. It is important for the valuation analyst to understand the role of valuation adjustments in the valuation process.

And, it is important for the valuation analyst to understand the procedures that enable the proper selection of valuation adjustments. An understanding of the difference between systematic and unsystematic adjustments allows

the valuation analyst to properly consider and estimate each type of adjustment.

In particular, this discussion summarized the four common methods for quantifying both systematic and nonsystematic valuation adjustments. Comparative conceptual and practical strengths and weaknesses of the various valuation adjustment methods were presented.

An understanding of these valuation discount and premium adjustment issues will allow the preparation of more credible taxpayer corporation unit valuation analyses.

Craig Jacobson is a senior manager in our New York City and Westport, Connecticut, offices. Craig can be reached at (646) 658-6231 in New York City, or (203) 221-3412 in the Westport, Connecticut office. He can also be reached at cajacobson@willamette.com.

Exhibit 3 Unit Valuation Adjustments List of “Top Ten” Caveats Regarding Valuation Discounts and Premiums

1. Valuation analysts should thoroughly understand the valuation analysis baseline or benchmark before applying any valuation adjustments.
2. Valuation analysts should thoroughly understand the economic influences of the specific systematic or nonsystematic feature considered; does it actually affect the investment risk or expected return of the subject taxpayer corporation/operating assets?
3. Valuation analysts should be careful not to double count valuation adjustments. For example, a valuation discount for the built-in gains tax may be a component of an overall discount for lack of marketability—and not a separate, discrete valuation adjustment.
4. Typically, when valuation analysts use alternative procedures to quantify valuation adjustments (e.g., income shortfall or excess, cost to cure, paired sales analysis), the lowest valuation adjustment indication is typically the most appropriate valuation adjustment conclusion.
5. Valuation analysts should not solely rely on published judicial precedent as the basis for selecting specific valuation adjustments, unless the facts and circumstances in the subject valuation are identical to those in the published decision.
6. Valuation analysts should be aware that not all valuation methods or indications may be subject to the same valuation adjustment or to the same magnitude (either dollar amount or percentage) of valuation adjustment.
7. Valuation analysts should recognize that the application of valuation adjustments is influenced by the purpose and objective of the analysis (e.g., the assignment standard of value, premise of value, etc.) as well as by the specific features of the subject taxpayer corporation/operating assets.
8. Valuation analysts should be sufficiently familiar with the content and intent of published empirical valuation adjustment studies before relying on such published studies as the basis of selecting a specific valuation discount or premium.
9. Valuation analysts should carefully consider the time period covered in any published empirical valuation adjustment study before relying on that published study for use as of a specific valuation date.
10. Valuation analysts should carefully consider the dispersion of the results reported in published empirical valuation adjustment studies. Valuation analysts should avoid the naïve reliance on the mean or median results of such published studies without considering whether such conclusions are applicable to the specific facts and circumstances of the subject unit valuation.