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Valuation Discounts for Gift and Estate Tax Savings

Valuation discounts, which are commonly used for business appraisals for private investment partnerships, minority interests in limited liability companies (LLCs), and family limited partnerships (FLPs), are immensely beneficial for gift and estate tax savings. In fact, applying discounts can reduce valuations for estate tax purposes while simultaneously allowing you to gift your children a percentage of the business, LLC, trust, or FLP at a reduced rate.

Itâ??s important to know that the standard of valuation for gift and estate tax purposes is defined as *fair market value*. This is the price at which the business, LLC, trust, or FLP would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Fair market value is the sale price that a hypothetical buyer and seller would reach, not the price that the actual owner would agree to or the price an actual buyer might be willing to pay.

Part of Every Gift and Estate Tax Savings Strategy

To be eligible to receive valuation discounts, an individual may choose to split up ownership of their business, LLC, trust, or FLP, especially for family-owned or closely held assets. Although it is best practice to craft an estate strategy based on the assets you own during your lifetime, these same valuation discounts would also apply to someoneâ??s estate. For instance, in the event that a person passes away while still owning a business and leaves all of their assets to their six children, all six children would be entitled to many of these discounts.

Common Valuation Discounts

The most common valuation discounts are those for lack of marketability, lack of control, minority share, and future interest discounts. These discounts can range from 10 to 45 percent, depending on several factors.

Lack of marketability: This refers to the discount that can be applied when valuing a company that is not publicly traded. Determining lack of marketability often means calculating the value of a closely held businesses or of restricted shares of public companies. The idea is that a discount exists between a stock that is publicly traded (and therefore has a market) and a privately held stock, which often has little if any marketplace. In other words, because a privately held stock does not have clear market value (the way that a publicly traded stock does), it deserves a discount.

Lack of control: This refers to a reduction in a companyâ??s share value due to a shareholderâ??s lack of ability to exercise control over the company. In this circumstance, a business interest is considered to be worth less than a controlling interest in a company, since business decisions, like determining compensation, setting policies, deciding to sell or liquidate, and declaring dividends, are all out of the shareholderâ??s hands. Thus, when noncontrolling or nonvoting shares are valued for a private company, a discount for lack of control is often applied.

Valuation Discounts Can Make a Big Difference

Jane is a 49 percent non-managing owner in an FLP. The FLP owns $10 million in commercial real estate, $7 million in liquid investments, and $25 million in private equity and hedge fund investments. That's a grand total of $42 million in value held within the FLP. Jane's 49 percent of the assets equals $20,580,000. If she chooses to gift her shares to her children, Jane is entitled to several discounts.

- Jane is a minority shareholder. This means she may be entitled to a 25 percent discount.
- Jane is a non-managing owner of the shares, so she may also receive a lack of control discount, which may be another 25 percent.
- Jane may receive an additional discount for lack of marketability, since it would be rather difficult to sell her minority share, for which she has no control of the underlying investments. That discount could be 10 percent.

After all the discounts, Jane would be able to gift her entire interest in the FLP to her children and use only $10,418,625 of her lifetime estate exemption. Valuation discounts are a powerful tool.

Minority share: You can obtain minority interest discounts by making each gift of an interest in the business small enough to qualify for the minority share discount. The minority share discount, also called a minority interest discount, reflects the idea that a partial ownership interest may be worth less than its pro rata (proportional) share of the total business. For example, ownership of a 30 percent share in the business may be worth less than 30 percent of the entire company value. This is because

a 30 percent ownership may be limited as to the scope of its control over critical aspects of the business, such as management, financial or accounting oversight, regulatory or legal issues, and even hiring and firing decisions.

Future interest: Future interest discounts are common when setting up trusts like qualified personal residence trusts that entitle the beneficiary to the asset a specified number of years in the future. Since it is a gift of future interest, the asset can be discounted based on an assumed interest rate of growth.

Determining the Discount

Individuals will need a qualified business appraiser or skilled valuation analyst to determine an appropriate discount based on an analysis of the assets held by the entity and their condition, the size of the interest being gifted, and restrictions outlined in the operating agreement.

Many factors enter into a business valuation, and specific facts surrounding the transfer will weigh heavily into the discount. These restrictions often significantly limit the power of minority interest holders to vote, participate in management, replace managers, force distributions, liquidate assets, and transfer or sell their ownership interest.

If individuals are making gifts over a period of years, experts recommend undertaking a valuation with each gift, as closely to the time of transfer as possible.

Current Tax Law and Valuation Discounts

Under the current tax law, individuals can give $13.61 million per person or $27.22 million per married couple in gifts over the course of their lifetimes without having to pay gift taxes. However, this provision is set to expire at the end of 2025. Based on the many tax proposals currently being discussed, it is possible the threshold may be reduced to a lower number even sooner.

To take advantage of possible grandfathering for transactions completed before the effective date of any proposed regulations, individuals already engaged in transfer planning with family limited partnerships and LLCs should complete the process in a timely manner, while those seeking to rely on existing laws should begin planning immediately.

Legal Notice

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