Business Interests Discounts

This memo discusses the rules for the valuation of assets for estate, gift, and generation-skipping transfer ax purposes. The valuation rules are important because they play an integral role in determining the amount of estate, gift, and generation-skipping transfer tax due on the lifetime and testamentary transfer of assets. The Treasury Regulations (the "regulations") provide a general definition of fair market value and specific valuation rules for certain assets. The primary purpose of the regulations dealing with valuation is to provide guidance in determining the fair market value of property at the valuation date. As a general definition, the Regulations set forth fair market value as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Treas. Reg. §§ 20.2031-1(b); 25.2512-1.

The valuation of assets can also play an important role in planning for the disposition of assets during life and upon death. Certain techniques can be implemented to decrease the value of an asset prior to its disposition in order to reduce any gift or estate tax liability. Such techniques use fractional interest discounts, minority interest discounts, lack of marketability discounts and discounts on capital gains as a device to decrease the value of an asset.

Business interests may be discounted if there are restrictions on ownership. Essentially, discounts are used because the value of a closely-held business as a whole is not equal to the sum of its parts. Thus, a ten percent ownership interest in a business is not necessarily worth ten percent of the entire value of the business. The minority interest may be worth less than ten percent because there is no control over the management of the business or because there is no readily available market to liquidate the interest.

The most common discounts for business interests are: minority interest discount, lack of marketability discount, and discount for built-in capital gains.

Minority Interest Discounts.

The holder of a minority interest in a business, whether as a minority shareholder in a corporation or a limited partner in a limited partnership, lacks the ability to control the business. Since a prospective purchaser of a minority interest could not unilaterally make management decisions or control the distribution of dividends, the purchaser of the minority interest would naturally seek to pay a discounted value for such interest.

> **EXAMPLE:** A owns 100% of a closely-held corporation. A gives 25% interests in the corporation to each of A's four children. Each gift will be valued separately and a minority interest discount can be taken for each child's 25% interest. The ownership interest of each child will not be attributed to the others based on their familial relationship. Rev. Rul. 93-12, 1993-1 C.B. 202. Note that the opportunity to obtain a minority interest discount is lost if the entire 100% interest is included in A's estate at his death.

Even though a particular minority business interest lacks control, both the IRS and the Tax Court have stated that no minority discount is available if the purpose of the transaction creating the minority interest is solely to avoid tax. In *Estate of Murphy v.*

Comm'r, T.C. Memo. 1990-472, the Tax Court denied minority interest discounts for both gift and estate tax purposes where, 18 days before the decedent's death, the taxpayer made gifts designed to reduce her interest in a corporation from 51.41% to 49.65%, on the grounds that the transfers were made purely for tax avoidance. But see *Estate of Frank v. Comm'r*, T.C. Memo. 1995-132 (court declined to apply substance over form doctrine to disregard the form of transfers).

In Rev. Rul. 93-12, 1993-1 C.B. 202, the IRS stated that each individual's equity interest in a business is to be valued separately and there is no attribution of ownership among family members. However, the IRS has asserted that a premium should be added to the value of a minority interest in a business if that minority interest can be combined with another interest to gain control of the business. If each of two individuals has a 45% interest in a business and the interest being valued is the remaining 10%, the IRS may argue that the 10% interest has an additional value, above and beyond its minority interest value, as a "swing vote" because it can be combined with one of the other two interests to gain control of the business. See, e.g., TAM 9436005; *Estate of True v. Comm'r*, T.C. Memo. 2001-167 (rejecting IRS position that a decedent's 38.47% interest in a general partnership was not entitled to a minority interest discount because it was the largest single block of voting rights in the partnership and could be combined with another block to control the partnership), *aff'd*, 390 F.3d 1210 (10th Cir. 2004).

The Tax Court, in *Estate of Magnin v. Comm'r*, T.C. Memo 2001-31, held that the IRS' swing vote theory works only where a minority interest owner has definite ability to gain control of the business. It must be likely that a hypothetical willing buyer can gain control of the business by combining with another shareholder. The hypothetical buyer must be considered without reference to the actual position of the minority interest holder. Therefore, if the minority interest holder has a definite ability in a unique position to combine his interest and take control of the business, that position must be ignored for valuation purposes.

> **EXAMPLE:** Father owns a 35% interest in X Co. Father's Son owns a 16% interest in X Co. The remaining 49% of X Co. is owned by one hundred different individual investors with no one investor owning more than 1%. Even though Son could combine his shares with Father to gain control of the business, a hypothetical buyer, one not in the same position as Son, could not be assumed to have the same ability to gain control of the business. Therefore, a swing vote premium is not appropriate. The hypothetical buyer rule is an objective standard that does not take into account the special relationship of Son and Father. A hypothetical willing buyer probably would not have the same relationship and, therefore, would not pay a premium for the minority interest.

Aggregation of Separate Interests Held by the Same Person. The IRS has attempted to aggregate blocks of a particular business interest owned by the same person, but in different capacities, such as stock held in a trust for the taxpayer's benefit and stock held outright. Rev. Rul. 79-7, 1979-1 C.B. 294. The courts, however, have been less prone to aggregate such interests. Both the Fifth Circuit and the Tax Court have ruled that a beneficiary's interest in real estate held in a QTIP trust cannot be aggregated with other directly-held real estate interests in the same property for purposes of determining whether a controlling interest exists. *Estate of Bonnor v. U.S.*, 84 F.3d 196 (5th Cir. 1996); *Estate of Lopes*, T.C. Memo. 1999- 225; see also *Estate of Bailey v. Comm'r*, T.C. Memo. 2002-152 (involving stock interests); *Estate of Nowell v. Comm'r*, T.C. Memo. 1999-15 (involving limited partnership interests). The IRS has acquiesced in the Tax Court's position. AOD 1999-0006. However, the Tax Court has aggregated stock held by the decedent outright and stock over which the decedent held a power of appointment. *Estate of Fontana v. Comm'r*, 188 T.C. 318 (2002).

Size of Minority Interest Discounts. The amount of the minority interest discount varies. The IRS and the courts typically allow up to a 30% minority interest discount. Other special circumstances may justify a discount that is higher than 30%.

> **Planning Point:** A minority interest discount should be taken whenever a block of stock lacks control over a closely-held business. However, the amount of the minority interest discount should be carefully considered. While a sizable discount (e.g., over 30%) may be appropriate, an overly aggressive discount may end up costing the client more than the financial benefit derived from the discount itself. A balance should be sought between the tax potentially to be saved as a result of the claimed discount and the time, cost and risk associated with defending the discount.

Lack of Marketability Discounts

The lack of marketability discount is a separate and distinct concept from a minority interest discount. While the two discounts may be somewhat related and often are used to discount the same interest, lack of marketability focuses on the ability of the investor to liquidate the interest. Therefore, it can apply to both a minority and a majority interest in a closely-held business, provided there is no readily available public market for the business interest. *Winkler v. Comm'r*, T.C. Memo. 1989-231. Of course, a controlling interest is more desirable and, therefore, may be easier to liquidate, but that consideration is merely a factor in determining the size of the lack of marketability discount, not the availability of the discount.

Size of Lack of Marketability Discounts. The size of the lack of marketability discount depends on the facts and circumstances of the business. Even though some appraisers have taken lack of marketability discounts of up to 70%, the courts tend to limit the lack of marketability discount to approximately 30%. See, e.g., *Mandelbaum v. Comm'r*, T.C. Memo. 1995-255. Assuming both discounts (minority interest and lack of marketability) are applicable, one aggregate discount percentage is often calculated to reflect both discounts.

Factors Affecting Size of Discount. The lack of a public market is not the only factor that makes an interest unmarketable. Restrictions on the sale of the interest, such as options or buy-sell agreements, may justify a lack of marketability discount. However, not every option contract will reduce the value of the business interest. Treas. Reg. § 20.2031-2(h) states that an option contract held by a decedent that would allow him to dispose of the underlying securities at any price he chooses during his life will be given little weight. Buy-sell agreements and similar arrangements may give rise to a lack of marketability discount, assuming they do not run afoul of IRC § 2703, discussed below, which nullifies the effect such agreements have on the valuation of a business interest in certain circumstances.

Other restrictions on selling the interest can also give rise to a lack of marketability discount. Closely-held stock that cannot be sold for a certain period of time, because of agreements among the owners or because of securities laws, can result in substantial discounts. See, e.g., *Okerlund v. U.S.*, 53 Fed. Cl. 341 (2002), *aff'd*, 365 F.3d 1044 (Fed. Cir. 2004). The cost of potential litigation may also be relevant in determining this discount. *Estate of Newhouse v. Comm'r*, 94 T.C. 193 (1990).

Discount for Built-In Capital Gains

A discount may be appropriate where an entity, such as a corporation or a partnership, holds an asset with a built-in capital gain. The IRS has suggested that the discount can be taken as a decrease in the entity's income stream or as a liability of the entity. IRS Guide for Income, Estate and Gift Taxes (May 1997).

Courts also have been willing to allow for these built-in capital gain discounts. See, e.g., *Eisenberg v. Comm'r*, 155 F.3d 50 (2d Cir. 1998). Still, however, the application and size of this discount will depend on the facts and circumstances. The size of the discount is largely determined by the likelihood of the recognition of the capital gain. The appraiser must discern the weight a willing buyer would place on purchasing the business interest with such a tax liability. For example, in situations where it is unlikely that a corporation would be liquidated and no disposition of the business' assets is expected to occur in the near future, the present value of the potential tax liability at a far off future date may be nominal. See, e.g., *Estate of Gray v. Comm'r*, T.C. Memo. 1997-67. If liquidation is likely, however, a discount for the tax liability flowing from such liquidation should be taken into account. See, e.g., *Estate of Davis v. Comm'r*, 110 T.C. 530 (1998).

The Fifth Circuit has stated that the weight to be given to such potential taxes should be the affect such potential taxes would have on a willing buyer. This same court added that when determining the asset-based value of a family-operated, closely-held corporation, there should be a dollar-for-dollar discount for the tax liability. However, the tax liability would not be considered in determining the earnings-based value of the business because this valuation assumes that there will be no sale of the assets. *Estate of Dunn v. Comm'r*, 301 F.3d 339 (5th Cir. 2002). The dollar-for-dollar discount was rejected in *Davis* because there was no planned liquidation or asset sale as of the valuation date. When the Eleventh Circuit was faced with this issue, however, it followed *Dunn* instead of *Davis*, even though there was no planned liquidation. *Estate of Jelke v. Comm'r*, 507 F.3d 1317 (11th Cir. 2007).