CHAPTER 72

Valuation Discounts and Premiums on the Transfer of Business and Investment Entities

RON FEINMAN (Lynchburg, Virginia)

INTRODUCTION

In addition to providing for the orderly transition of management and ownership of a business as it is passed on to your children or other heirs, the use of entities such as Family Limited Partnerships and Limited Liability Companies afford an additional way to reduce estate and gift taxes that might be due when ownership of these entities is transferred. In this chapter we will discuss the transfer of interests in these types of entities solely focusing on limited liability companies (LLCs), but the concepts explained apply to partnerships as well.

As discussed in prior chapters, not counting annual exclusion gifts, if an individual dies and transfers more than the estate tax exemption amount ($2 million in 2008, and 3.5 million in 2009), the excess amount transferred will be subject to a gift or estate tax of approximately 45% or more. You must remember that of the total exemption amount, only $1 million per person may be utilized during lifetime. This $1 million is the lifetime gift tax exemption amount; the remaining exemption amount is applied to the estate of the donor at his or her death.

The IRS Regulations provide that a gift is valued for gift tax or estate tax purposes at its fair market value, the price for which it "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." In other words, what the asset would really be worth if you were to sell it on the open market.

An important distinction to keep in mind is the different way assets are valued for lifetime gift tax exemption purposes versus the way they are valued for estate tax purposes at death. For lifetime gifts, the value of each individual gift of an entity ownership interest is considered separately, no matter how many other similar gifts are made at the same time. As you will see below, treating each gift separately creates a very powerful benefit for our lifetime gifts. The business ownership interests remaining in one's estate at his or her death, however, are all combined or aggregated together before considering their fair market value. We will consider an example of this below.

TRANSFER ENTITY OWNERSHIP INSTEAD OF ASSETS DIRECTLY

The first way we are able to reduce gift or estate taxes comes from having special terms included in the legal documents setting up the LLC. These special terms affect who controls the operation of the LLC and how and when its ownership interests can be transferred to others. The effect of having these special terms is that they create valuation discounts for an interest in the entity when it is transferred.

Here is how this works: You first contribute the property you want to pass on to your heirs to the LLC in exchange for ownership interests in the entity, the same way a stockholder gives a corporation money in exchange for shares of its stock. For example, a husband and wife might contribute a portfolio of securities and other assets having a fair market value of $2 million to their brand new LLC in exchange for 100% of the ownership interests in the LLC.

Assuming there are no hidden liabilities, we would now assume the new LLC is worth about $2 million and that if you wanted to sell, say, 25% of the LLC to another, it would command a sales price of about $500,000. But what if the LLC documents were drawn so that even if you sold a partial ownership, you still had complete control over the management of the LLC and got to make all investment decisions? You also retained full control to decide when (and if) any distributions would be made from the LLC to its owners.

What would a reasonable person pay for a 25% ownership interest in such an LLC? What would you pay for an ownership interest in a company where someone else made all the investment decisions, and you couldn't ever get any earnings back without someone else's permission? At this point we can safely say the value of a 25% interest would definitely be less than $500,000. We call this reduction in value a lack of control discount.

Let's suppose that in addition to you retaining control over the management of the LLC, the new purchaser cannot sell or transfer his or her 25% share without your permission. Not only that, but he or she cannot even use the ownership interest in the LLC as collateral for a loan. In other words, the purchaser is dependent on you to get his or her money, including any earnings, out of the LLC; it has become a very illiquid investment. Now how much would you pay for such an interest? As with the lack of control restrictions, these provisions would clearly reduce the amount someone would be willing to pay for partial ownership in the LLC. We call this reduction in value the lack of marketability discount.

The size of these discounts is determined by using a qualified independent appraiser to examine the LLC documents, the underlying assets of the LLC, the state laws governing LLCs, and the current market for such interests. After this review, the appraiser will assign a value to the various discounts as they apply to the interests in the LLC. Applying these discounts will reduce the amount of the underlying value of the assets recognized for our gift tax calculations upon transfer.

Returning to our example, the appraiser might assign a discount of 25% for the lack of marketability discount and a 15% discount for lack of control. The discounts are applied sequentially, resulting in a cumulative discount of 36.25%. Here's how the value of our 25% interest in the LLC is now computed:

Underlying asset fair market value:	$500,000
LESS 25% marketability discount ($500,000 x .25)	-125,000
	$375,000
LESS 15% lack of control discount ($375,000 x .15)	56,250
VALUE after both discounts	**$318,750**

The cumulative discount is $181,250 ($125,000 + $56,250), which is 36.25% percent of the underlying value of the assets ($181,250 ÷ $500,000 = .3625).

THE SAVINGS

Assuming you have a taxable estate, what are the real benefits to you if you make use of these discounts for gifting to your children? There are several:

1. You can transfer more value during your lifetime. Instead of only being able to transfer $1 million in value with your $1 million lifetime gift tax exemption amount, you can now transfer approximately $1,568,000 of value.
2. As with any gift made during life, you have removed all future increases in value from your estate. So if the $1,568,000 were to double in value by the time of your death, the total amount transferred at that time would be $3,136,000 — all from just using your $1 million lifetime exemption amount!
3. The estate and gift tax savings, assuming the value doubled, and using the 45% transfer tax rate, would amount to $774,300! ($2,136,000 x .3625 = $774,300).

   But what about the restrictions? In most cases they actually provide another benefit:
4. The value of the gift is transferred to you children, but you remain in charge of all the important decisions concerning the underlying assets. You maintain control over how they are invested, and when any distributions are made to the children. The lack of marketability restriction assures you a child can't sell the assets to a stranger. The restrictions allow you to protect your children from taking improvident actions until you feel comfortable they are mature enough to do so.
5. Additional special planning techniques can be combined with LLCs and similar entities to provide even more benefits, such as preserving a step

up in basis at death for the ownership interests transferred, or even additional transfer tax savings by combining techniques to achieve multiple discounts above those discussed here.

THE CONTROL PREMIUM

One final note: In the same way the restricted interests receive a discount because of lack of control and lack of marketability, the ownership interest you retain will actually receive an increase in value, known as a control premium, reflecting your authority over all the interests in the LLC. This may range from 15% to 40%[1]. A method to reduce the impact of this increase in value is to make sure only a small percentage of ownership represented by interests with a control premium is retained by you. For example, if the underlying assets are valued at $1 million and you retain a 1% controlling interest with a 35% premium, this 1% would be valued at $13,500 instead of $10,000, a relatively minor adjustment in the overall scope of things.

A SKILLED PROFESSIONAL ADVISOR TEAM IS VERY IMPORTANT

The foregoing techniques involve sophisticated planning with many tax and other legal traps. As you would expect, ensuring you employ a skilled attorney to draft the proper documentation, utilizing a knowledgeable and competent appraiser, and preparing proper accounting and tax filings is of tantamount importance.

Attorney Ron Feinman graduated from UVA Law School in 1979 and has a nationwide practice centered in Lynchburg, Virginia, in estate, business, and legacy planning, elder law, and asset protection.

1. In other circumstances where control is exercised by a majority interest, a relatively small ownership percentage may also receive an increase in value. For example, if three individuals own 48%, 48%, and 4% of the ownership interests, the 4% owner can decide who controls the entity by choosing with which of the other owners to vote his interest. This ability is known as a swing vote premium, and his interest would be valued at more than 4% of the underlying assets.