



7007 College Boulevard Suite 400  
Overland Park, Kansas 66211  
tel: 913.897.3599  
info@AlliedBizGroup.com  
www.AlliedBizGroup.com

## Valuation Basics for Charitable Gifting

*By Kelly Skarda, Allied Business Group, Inc.*

When many business owners think about giving to charity, a traditional cash donation first comes to mind. For some potential donors, however, a meaningful cash donation may not be feasible. One alternative is gifting a portion of their business, in the form of company stock, to a charitable organization. Business owners may not be aware that private companies of nearly any size can take advantage of this gifting opportunity.

There are many options available to maximize benefits for both the donor and the charity. Arrangements can even be made to ensure that the donor will receive a lifetime income stream. When considering gifting stock, business owners should consult with their legal and tax professionals to decide what their best options are.

After the terms of the gift have been finalized, an agreement is created to complete the transaction. The gift agreement will outline the rights and responsibilities of both the donor (business owner) and donee (charitable organization). A business appraisal may be performed if requested by the owner or if the gift exceeds the IRS-mandated value of \$10,000. The date of the gift agreement becomes the effective date of the appraisal. Accordingly, only information available on or before the effective date can be considered in determining the value of a gifted interest. Appraisals for the IRS must be performed by 'qualified appraisers,' which the IRS defines as an appraiser who has been accredited by a national appraisal organization

and regularly receives compensation for performing valuations.<sup>1</sup>

Gifts of closely held stock are generally minority interests. As such, the final value of the gifted stock will generally be less than the pro rata share of a 100 percent interest in the company. For instance, 20 percent of a company is not necessarily equal to one-fifth of the 100 percent value. The reason for this is that minority shares have an inherent lack of control and a lack of marketability.

To account for these characteristics, certain discounts are applied to determine the fair market value of the minority interest. The two discounts most commonly applied are a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM).

### **Discount for Lack of Control**

The DLOC reflects the lower value associated with ownership interests that cannot directly influence daily activities or policy decisions of a company. Because the minority interest (in this case, the charitable organization) does not have control over major decisions that can drastically impact the company's performance, its shares have a lesser value. The discount for lack of control reflects this lowered value and brings the value of the shares closer to fair market value.

---

<sup>1</sup> Internal Revenue Service, Instructions for Form 8283, Noncash Charitable Contributions.

The discount for lack of control is *lower* when the business owner provides the minority interest with some control attributes, a few examples of which include:

- Power to elect or have meaningful input in the election of directors or managers.
- Requiring consent from minority interests to amend an operating agreement.
- Providing the minority interest with a first right of refusal.
- Giving the interest sufficient votes to block certain actions (subject to state statutes and/or articles of incorporation).

### **Discount for Lack of Marketability**

The discount for lack of marketability is used to compensate for the difficulty of liquidating an interest in a privately held company. While shares of a public company can be traded on an exchange, minority shares in a closely held company are relatively difficult to sell (i.e., less marketable). The DLOM is intended to reflect the market's perceived reduction in value for not providing liquidity to the investor.

The discount for lack of marketability is *lower* when the gift agreement affords the minority interest with attributes that make easier to liquidate. Perhaps the most significant of these possible attributes is a 'put option,' a clause in the gift agreement that allows the minority shareholder (the charity) to sell its shares back to the company at any time. Assuming the put option has a reasonable prospect of being enforced and funded, it can dramatically reduce the DLOM since it provides significant liquidity to the minority shareholder. Other factors that may decrease the discount for lack of marketability include:

- Existing market for the interest being valued or imminent sale of the company. This increases the likelihood that the minority shareholder could sell its shares.
- Demonstrated integrity of the controlling shareholder ('quality management'). If the controlling shareholder is expected to be fair and to work in the best interests of minority shareholders, minority interests in the company tend to be more marketable.

- Removing any restrictions on transferring interests, and thus allowing the gifted interest to be sold.
- History of meaningful dividends or distributions. Companies that pay dividends tend to be more marketable than companies that do not.

Additionally, buy-sell agreements can either reduce or increase the DLOM, depending on the terms of the agreement. The agreement can guarantee a market for the stock (by outlining how another shareholder may purchase it) and make it more marketable, or it can put restrictions on the sale and make the stock less marketable.

As with all valuation discounts, determining an appropriate DLOM and DLOC requires thorough research and analysis of economic, industry, and company-specific factors. The business appraiser performing the valuation must consider all of these as well other quantitative and qualitative factors when determining the appropriate value of a company's stock.

### **Conclusion**

It is important to remember that there are many factors that will influence a company's value and the associated benefits of a stock contribution. Business owners wishing to contribute to a charitable cause should discuss the potential benefits of gifting with their professional advisors.