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How Valuation Discounts Can Protect Family Wealth

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Business owners considering gifting all or a block of stock in their privately held company have a unique opportunity in the current market. The value of public company stocks has decreased dramatically due to recent economic conditions. But what about the value of private companies in this market? For business owners seeking to gift stock in a privately held company, the timing may be ideal. The current business climate lowers the market values (and subsequent gift tax liabilities) for companies in many sectors. In addition to this reduced market value, adverse economic conditions allow business appraisers to support larger valuation discounts when valuing minority interests, which can further reduce the gifted stock's value and subsequent tax burden.

This article focuses on how business appraisers typically determine discounts applied to valuations for gift and estate tax purposes. Two discounts are generally applicable when an appraiser converts a controlling (i.e., majority) equity value to a minority, non-marketable value: discount for lack of control (DLOC) and discount for lack of marketability (DLOM).

Discount for Lack of Control (DLOC)

A controlling ownership interest is typically more valuable than a pro-rata share of a minority interest. This is because the minority owner does not have control over important business decisions like declaring dividends, determining compensation, setting policies and deciding to sell or liquidate. To account for this disadvantage, an appraiser can apply a discount for lack of control to a minority interest.

To determine the DLOC, appraisers often consider control premium—the typical increase in stock value after a company announces an acquisition—and invert it to arrive at a DLOC. Control premiums have averaged 30 percent over the past year, with a resulting in a lack of control discount of 23 percent. (Note: The average DLOC of 23 percent only applies to significantly small minority interests. Larger blocks of stock, which have comparatively greater control, may warrant a lower discount. Additionally, this broad average does not consider any individual factors of the subject interest that could influence the discount.)

Discount for Lack of Marketability (DLOM)

Minority interests in privately held companies are often difficult to sell. Consequently, an appraiser may apply a discount for lack of marketability (DLOM) that considers the difficulty and expense involved in liquidating such an interest. All else being equal, a minority ownership interest in a closely held business is worth less than a similar interest that is readily marketable, such as stock in a public company.

The level of discount applied to a specific interest depends on many factors, including dividend paying capacity, likely timeframe to liquidity, restrictions on transferability and the company's stock redemption policy, to name a few. The current market environment has negatively impacted the marketability of many privately held businesses.

Business appraisers have traditionally relied on two empirical benchmark studies—restricted

stock studies and pre-initial public offering (pre-IPO) studies—to determine marketability discounts. Restricted stock studies compare the trading price of a company's public stock with unregistered or restricted shares sold in private transactions. Pre-IPO studies examine the prices of stock while the company was still private, compared to the eventual IPO price. The studies have found an average DLOM in the range of 15 to 40 percent.

These methods continue to factor heavily in DLOM determination; however, other approaches have gained popularity as appraisers seek the most accurate ways to determine applicable discounts. Quantitative models, including the FMV Restricted Stock Study transactions and the Francis Longstaff Model, have become important resources in the valuation field.

The FMV Restricted Stock Study details nearly 500 transactions and allows for comparison of a subject company's marketability discount with those of other firms.

Longstaff's model considers two factors, the subject company's volatility (risk) and its liquidation period (time it takes to sell), in a mathematical framework based on the look-back option pricing theory. This model is based on the premise that a company's volatility and liquidation period are directly proportional to its DLOM. Thus, investments that have no price volatility or that are immediately marketable essentially have no DLOM.

Other methods appraisers often use include: Quantitative Marketability Discount Model (QMDM), LEAPS, CAPM-Based Approach and approved discounts in historical court cases.

Conclusion

DLOC and DLOM discounts are often misunderstood as quick methods of reducing a shareholder's tax liability. However, the discounts are neither automatic nor a simple average of an acceptable discount range. Determining how and when to apply these discounts depends heavily on the facts and circumstances of each appraisal, including the methods used to arrive at a company's value, the standard of value being applied and the level of control and marketability of the subject interest.

The scope and variety within the discount methodology make it easy to see how the application of proper discounts can drastically alter the concluding value (and thus tax burden) in a minority interest appraisal. The following example demonstrates the enormous potential benefit of ensuring that all applicable discounts are considered. If a company's controlling enterprise value has been estimated at \$10,000,000 and consists of 1,000 shares, the discount for lack of control and discount for lack of marketability can be calculated as illustrated below.

Reducing the equity value by nearly 50% also lowers the taxable amount and generates enormous tax savings, simply by accounting for the inherent characteristics of minority shares.

As previously cautioned, however, these discounts are both complex and ambiguous, with much being left to the discretion of the appraiser. Courts are requiring an increasing amount of rigor and analysis to support discounts in business appraisal reports. As such, it is vitally important to engage a qualified appraiser who thoroughly understands and can justify any valuation discount to the IRS or other relevant parties. The proper analysis and application of valuation discounts can carry enormous financial benefit for all participants in the gifting process—and safeguard a company's transfer in these uncertain times.

Example of Discount Savings

\$10,000,000	100 % Enterprise Value (1,000 shares)
\$3,000,000	Pro-rata value at 30% (before discounts)
(\$690,000)	Less DLOC (23%)
\$ 2,310,000	Marketable minority value
(\$690,300)	Less: DLOM (30%)
\$ 1,619,700	Minority, Non-Marketable Value
\$ 1,380,300	Total Reduction by Discounts