Lack of Marketability and Lack of Control Discounts

By

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I. Case I- Estate Whose Value Will Fall Short of the Lifetime Gift and Estate Exemption

Please note that steps others than those discussed herein can be taken to limit the taxable portion of a gift- like having the donor retain a life interest in the property. However, this is not discussed herein.

A. What is the Lifetime Gift and Estate Exemption and Where is it Headed?

The lifetime gift and estate tax exemption for 2023 was $12.92 million for individuals and $25.84 million for married couples filing jointly. For 2024, it is $13.61 million and $27.22 million, respectively. What this means is that in 2024 you can gift or transfer at death $13.61 million ($27.22 million for joint gifts) to your heirs or beneficiaries without having to pay an estate/gift tax.

For 2024, you can also give up to $18,000 (or $36,000 for spouses "splitting" gifts tax-free) to recipients without using any of your lifetime gift and estate tax exemption.

Caution: Remember the Lifetime Exemption is set to sunset back to $5,490,000 (2017 values) in 2027. If you believe this will happen, you need to consider using up - at least some- of the exemption if you expect that your taxable estate will be above $5.49 million (or $5.49 million indexed for inflation).

1. **For most individuals, it is highly probable that the value of their estate or the gifts made during their lifetimes will be below the lifetime gift and estate exemption- even if the exemption falls to $5.49 million. Under these circumstances waiting to transfer assets until date of death (even if an estate tax has to be paid) maybe advantageous because of a step-up in basis.**

Caveat 1: The health of the donor and the financial acumen of the recipient are not considered herein.

B. What is Tax Basis for Gift and Estate Tax Purposes and What is the Notion of a Step-Up in Basis Important

1. Recipient's basis when property is gifted

If an asset is gifted during life to a third party, the person receiving the gift (the "donee") takes what is known as a "**carryover basis**", such that the donee's basis is the same as that of the donor, whether that is the cost basis or adjusted basis. This is generally the rule for any appreciating asset (like land) gifted during the life of the donor. If the donee sells the appreciating asset, the taxable gain is computed as the difference between the net proceeds from sale and the donee's basis.

2. Donee Basis when property is received from Decedent

Generally, the basis of property received from a decedent is the fair market value at the date of death of the decedent according to IRC § 1014. This is generally called a "step-up" in basis. SO as long as the property has increased in value in the hands of the decedent, the heirs to the property will have a tax basis equal to fair market value of the asset at the date of death. The benefit to those inheriting appreciating property is that this step-up in basis can reduce or eliminate capital gains taxes on the property when it is sold.

Example 1: Steve buys a building for $10 and owns it for 3 years at which time the basis of the property is $7 and its market value is $15. Steve then gifts the property to the son who turns around and sells it for $20. Steve can use his unified credit to avoid any gift tax. His son, however will pay long-term capital gains tax on a gain of $13 ($20 selling price less Steve's basis of $7).

If Steve dies and wills the property to his son (at which date the FMV of the property is $20), the son will pay no taxes on its sale.

Caveat 2: Remember Congress has and (may in the future) introduce legislation that could do away with the step-up in basis. If this occurs, the tax basis to the recipient of a gift during lifetime or at date of death would be similar.

Takeaway 1: Know the value of your estate, consider where the unified credit limit is heading and use this information along with your knowledge of how basis is determined to maximize intergenerational wealth.

C. **Could it be advantageous on an intergenerational basis to pay some estate tax so that the next generation receives a step-up in basis?**

Clearly yes.

<u>Example 2:</u>

Suppose that the Steve owns land with a current fair market value of $20 million and a basis of $5 million. Suppose in 10 years Steve believes he will be dead and that the property will be worth $25 million (assume the estate and gift tax exemption will be $13.62 million now and in 10 years).

Options

Option 1: Assume Dad gifts the property to child, child then sells the property for $20 million 5 years from today. Tax consequences dad pays gift taxes on $20 million -$13.62 million-$18,000 (assume this equals $2 million). Child's adjusted basis is $5 million. Child will now pay long-term capital gains taxes on the sale equal to $15 million at 20% (approximately). Assume that the child can invest the money at 5% (FV factor 5 years 5% =1.28)

Outcome: Dad pays no gift tax. Family wealth at date of death- $20 million -$2 million gift taxes-$3 million LT cap gains taxes. = $15 million *1.28=$19.14 million

Option 2: Dad transfers property to child at death. Dad's estate pays estate tax on $25 million - $13.62 million -$18,000 (say at 40%). Child sells property for $25 million with no long-term capital gains tax.

Family wealth = $25 million -$4.56 million in estate tax. =$20.44 million

Net Advantage to Paying the Estate Tax =$1.3 million.

II. Estate Will Exceed the Lifetime Exemption

A. Your objective now is to make your lifetime exemption go as far as possible- But How?

One way to do this is to structure your business dealings to optimize the lack of control and lack of marketability discounts that are available for gifts made or to the estate.

Example 3: Suppose that your farmland has been appraised for $10 million. Absent the application of a lack of control/lack of marketability discount a 30% gift of the farmland would result in the use of $3 million of your lifetime exemption (less $18,000). In contrast, if a 25% lack of control discount and a 25% lack of marketability discount were available as offsets to the land value, the amount of the lifetime exemption used as the result of your gift would be $3 million*.75*.75 or $1,687,500 or approximately $1.3 million less than that without such discounts.

1. What is Control or Lack of Control

An individual (or trust) that owns more than 50% of the voting equity of an entity is said to have a controlling interest in that entity. Those with less than 50% ownership are viewed as having a non-controlling interest.

Controlling interests are viewed as more valuable than non-controlling interests. Such a conclusion has been validated in the markets for publicly traded companies where it is often the case (although not always) that a buyer of a controlling interest pays a higher per share price to acquire the control of an entity.

Bottomline: Control has value. Therefore, transfers of less than a controlling interest in an entity or the holding of less than a controlling interest in an entity by an estate will lead to taxable gifts or a taxable estate that is less than what would otherwise be the case were the holdings controlling in nature.

2. How To Avail Yourself of Lack of Control Discounts- Approach 1

Do Not Own the Property Individually- Transfer Ownership into an LLC (I say LLC simply because it gives you degrees of freedom that other ownership structures do not.

For Example: Let's say Mom and Dad own 400 acres of farmland valued at $3 million. If Mom and Dad were to die with the land titled in their names, the land would be valued at $3 million in their estates less costs to sell. The land is valued as such because Mom or Dad can cause the land to be sold at any time through partition and receive full, fair market value.

Now, let's say Mom and Dad transfer the land into an LLC. The LLC's operating agreement includes the following provisions:

- Land may not be sold without majority consent of ownership

- Money cannot be distributed out of the LLC without majority consent
- The LLC cannot be dissolved without majority consent

At the time of the formation of the LLC, Mom and Dad gift a 0.5% ownership interest to their son and daughter. After the gifts, Mom and Dad are now 49.5% owners of the LLC.   Now, neither Mom nor Dad can singularly control anything that happens with the LLC. Due to the lack of control created by the terms of the LLC operating agreement and the minority ownership (49.5%) held by Mom and Dad, Mom and Dad's interest in the LLC is viewed as being worth 20 to 25% less than would be the case if they were to hold the land individually. This 20 to 25% reduction in value is due to Mom and Dad's lack of control.

By structuring their business affairs in this manner, Mom and Dad have reduced the value of their estates (and potential estate taxes as well). Assuming a 40% estate tax rate, Mom and Dad will save son and daughter $300,000 in estate taxes ($3 million in land times a lack of control discount of 25% times a 40% estate tax = $300,000).

Takeaway 2: Lack of control discounts can save many thousands, if not millions, of dollars in estate and gift taxes for farm families.

3. How To Avail Yourself of Lack of Control Discounts- Approach 2

In the above example Mom and Dad each own 49.5% (or a non-controlling interest) in the LLC that owns the farmland. The downside of this arrangement is that the children now could have a say in the way the farm is run (either by siding with Mom or Dad). Is there something that can be done which keeps control in the hands of just Mom and Dad but which still allows for lack of control discounts for any further gifts made by Mom or Dad?

Yes **create voting and non-voting member units**. Split the voting member units 50/50 between Mom and Dad and then gift the non-voting units. Once this is done, Mom and Dad each have a noncontrolling interest and any gifts of Mom or Dad's non-voting or voting units would be considered non-controlling in nature.

Example 3: The entity that Mom and Dad creates issues two classes of ownership units (voting and non-voting)- 100 units of voting and 9,900 non-voting member units. Initially Mom and Dad gift the non-voting units to children thus preserving a lack of control discount when making the gift.

Next Mom and Dad could gift a portion of the voting units, with these gifts also being non-controlling in nature

Caveat 3: Keep in Mind That There are Costs Associated with Transferring Farmland into a Separate Entity (Like an LLC)

The primary downside of transferring farmland into an LLC to gain lack of control discounts is the cost of establishing and maintaining the LLC. Initial startup and deed

expense could run around $5,000. The LLC will also need to maintain a bank account to collect rent and pay expenses such as real estate taxes. Additionally, the LLC will be required to file a tax return each year.

In addition, if family ties are not strong, the creation of a LLC where Dad and Mom each own less than 50% interests could create some unintended family dynamics.

B. Maximizing the Lack of Marketability Discount

1. What Causes a Lack of Marketability

Privately held companies do not have a readily available market where they can be easily and quickly sold, with cash changing hands at the moment of sale. In contrast, publicly traded companies are readily marketable, with ownership interests in such companies being easily bought and sold.

As an example. The other day I was researching the amount of time it would take to sell a welding and repair company with sales of $1.5 to $2 million. Based on a review of databases, I determined that on average it took better than 200 days to sell such a company (BTW this is not unusual for privately held companies and remember this was the time it took to sell a 100% interest in the company- how long do you think it would take to sell a 5% interest?). Now consider trying to sell a 5% interest in a company that is only marginally profitable- could such an interest even be sold?

Bottomline: Marketability has value. Therefore gifts of a non-marketable equity interest or the holding of equity interests by an estate that are non-marketable in nature have lower values than what would otherwise be the case were the holdings more marketable in nature.

2. What determines the size of a lack of marketability discount

Know the Mandelbaum Factors

The factors identified in Mandelbaum vs. Commissioner are often used to determine the lack of marketability discount for privately held companies. These factors include:

- Financial statement analysis
- The Company's dividend/distribution policy
- The nature of the Company, its history, its position in the industry and its economic outlook
- The Company's management team
- The amount of control present in the equity interest
- Restrictions on the transferability of the equity interest
- Required holding periods for equity interests
- The Company's redemption policy for equity interests

- The costs associated with making a public offering of the stock of D.W. Dickey & Son, Inc.

1. Financial Statement Analysis. The Financial Statement Analysis provides insights into the financial strengths and weaknesses of the Company. with this judgement taking into consideration the Company's consistency in operating profits/revenues (more variability in profits and , its debt and liquidity positions and its activity ratios.

Poor financial performance and condition increases the the lack of marketability discount.

2. Investors consider a company's dividend policy when choosing companies to invest in and in valuing the equity of these companies.

Overall, the lack of a payment of on-going dividends favors an above average lack of marketability discount. You should temper this discount for the lack of payments of dividends however if a Company has sizable amounts of retained earnings and therefore the ability to pay dividends. However, when valuing a non-controlling interest this ability to pay dividends has less weight since a non-controlling owner could not force the payment of dividends out of the Company's existing retained earnings.

3. Nature of the Company, its History, its Position in the Industry and its Economic Outlook. Investors generally consider the nature of the company, its history, its position in the industry and its economic outlook as important contributors to its value. Older businesses, more profitable businesses and those operating in less risky industries (where risk can be measured in terms of the nature of the work performed, the relative profitability of the industry, growth prospects for the company, the competition the company faces for its customers and the cyclicity of the industry in which it operates).

4. Company Management. A company's management is an integral piece of the valuation puzzle. Good management is known to increase the value of a company just as poor management diminishes its value.

Lack of marketability discounts tend to be lower when good management is in place and willing to work for new owners

5. Amount of Control in the Transferred Shares. Control over the business affairs of a company is important to an investor. Control allows an investor to dictate policies, procedures and actions that can be more favorable to the investor. Because of this, lack of marketability discounts are lower for ownership interests that have control over the business affairs of the company than ownership interests that do not provide for control.

6. **Restrictions on the transferability of equity interests**. Investors prefer investments that are more liquid and therefore will discount the price of an investment that has restrictions on transferability.

Lack of marketability discounts tend to be lower if the equity holders of a company face only limited restrictions on their ability to sell their interests.

7. Holding Period of the Equity. The length of time that an investor must hold onto his/her investment in a company before it can be sold impacts the discount for lack of marketability. This is because longer holding periods limit the investor's ability to take advantage of potentially favorable short-term market conditions. Also, it is known that market risk increases with the holding period.

8.The Company's Redemption Policy. A company's redemption policy is a factor that can enhance or detract from the value of an equity investment.

The lack of a formal redemption policy favors an above average lack of marketability discount for the Company's common and preferred stock.

9. Costs Associated with Making a Public Offering. Investors must consider the costs of taking a company public when deciding on how much to pay for a non SEC-registered equity interest. The reason for this is that a non-registered equity interest may be more valuable if it were to be publicly listed. To publicly list an equity interest, however, can be very costly. If some of this cost could be borne by the seller, or the investor were to have some ability to keep registration costs down, the investor might be willing to pay more for the company's stock. As such, lack of marketability discounts are smaller if a company is close to being publicly listed.

Caveat 4: Finding a buyer to purchase a small, non-controlling interest in a privately held business that has paid dividends only once over the past 11 years would most likely prove difficult.

Court Cases and Decisions with regards to Lack of Marketability Discounts

1. Estate of Mandelbaum v Commissioner, TC Memo 1995-255. At issue in this case was the proper level of lack of marketability discount to apply to gifts of a non-controlling equity interest in a family owned business. The taxpayer's expert felt that a proper discount was 70 percent for certain gifts and 75 percent for others.

The Court held that the expert's analyses were not persuasive and did its own calculation of a proper lack of marketability discount to apply. Starting with a benchmark 35 percent lack of marketability discount, the Court adjusted this discount taking into account 9 factors including : (1) the company's financial position, (2) the company's dividend policy, (3) the nature, history and position of the company and its economic outlook, (4) the company's management, (5) the level of control contained in the gifted shares, (6) the transferability restrictions on the gifted shares, (7) the required holding period for the gifted shares, (8) the company's stock redemption policy and (9) the costs of an initial public offering of the company's stock. The Court decided that 5 of the 9 factors implied a below average lack of marketability discount, 2 implied an above average lack of marketability discount and 2 of the factors were neutral with respect to a lack of marketability discount. Based on its analysis, the court applied a 30 percent lack of marketability discount.

2. Barnes v Commissioner, TC Memo 1998-413- This case involved gifts of stock of two South Carolina telephone companies. The Court agreed with the taxpayer's expert and applied a 40 percent lack of marketability discount to the Home Telephone voting stock and a 45 percent lack of marketability discount to the Rock Hill Telephone Company non-voting stock. The Court based its decision on the following:
    - The Barnes family had controlled Rock Hill for 80 years and the Hemly and Barnes families had controlled Home for 50 years.
    - Both families intended to keep control of the two companies.
    - The families had taken steps to bring in younger family members and had taken measures to avoid having to sell shares to pay death taxes.
    - Home and Rock Hill paid much lower dividends than the guideline companies.
    - There had been so few sales of Rock Hill stock and only limited family and insider sales of Home stock had occurred and had occurred at about book value.
    - The Home and Rock Hill stocks were not registered or traded on any exchange or over the counter.
    - The Home and Rock Hill stocks being valued represented very small minority interests that had no ability to direct the affairs of either company or cause the sale of their assets.