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. What about the value of private companies in the market? The timing may be ideal for business owners seeking to gift stock in a privately held company. The current business climate lowers the market values (and subsequent gift tax liabilities) for companies. 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 paper focuses on how business appraisers typically determine discounts applied to valuations for gift and estate tax purposes. Two discounts are generally applicable when appraisers convert a controlling 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 few years, equating to a 23 percent DLOC. (Note: this average applies to small minority interest versus large blocks of stock. Additionally, this does not cover 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. Everything 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 time-frame 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-IPO studies - to determine marketability discounts. Restricted stock studies compare the trading price of a company’s public stock with 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 between 15 and 40 percent.

The above methods continue to factor heavily in DLOM determination; however, other approaches have gained popularity. Quantitative models, such as the Francis Longstaff Model, have become important resources in the valuation field. Longstaff’s model considers two factors, the subject company’s volatility (risk) and liquidation period (time it takes to sell) in a framework based on the look-back option pricing theory. These two factors are directly proportional to a company’s DLOM. Other methods include: Quantitative Marketability Discount Model (QMDM), CAPM-Based Approach and approved discounts in historical court cases.

**Conclusion**

DLOC and DLLOM discounts are often misunderstood as quick methods of reducing a shareholder’s tax liability. However, 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. As previously cautioned, 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.

**Discount Application Example**

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.

$10,000,000  100% Enterprise Value (1,000 shares)

$3,000,000  30% Pro-rata Value (before discounts)

($690,000)  Less: DLOC (23%)

**$2,310,000**  Minority, Marketable Value

($680,300)  Less: DLOM (30%)

**$1,619,700**  Minority, Non-Marketable Value

In the above example, the total reduction of value by discounts amounted to $1,380,300. This reduction was nearly 50% of the pro-rata equity value. By reducing the equity value of the minority interest, the discounts lower the taxable amount and generates enormous tax savings, simply by accounting for inherent characteristics of minority shares.