Valuation Discounts for Family-held Businesses

Valuing a family business for the purposes of estate and gift taxes can be difficult due to the lack of an identifiable market for the business. The valuation is further complicated when the IRS does its own valuation at tax time. For families trying to pass a family-held business on to the next generation there are several valuation discounts available to protect a business's assets from undo taxation.

When a family business owner gifts ownership in the company to his or her children, the children typically become "minority" owners. Their shares are worth less to prospective buyers than the majority owner's shares. The IRS currently grants minority discounts as a way of recognizing that the "minority owner" of a family business (one who owns less than 50% of a business) cannot obtain the same price-per-share as the "majority owner" (one who owns more than 50% of a business). Minority discounts allow a minority owner to value shares lower when reporting to the IRS, and thereby reduce overall tax liability. No family business owner should be forced to pay more in taxes than the price the shares would obtain in the market.

Further, family business owners often place restrictions on the sale of the shares that they gift to their children, in order to ensure that ownership of the business stays within the family. These restrictions – a lack of marketability – reduce the value of the shares. Current law recognizes the reduced value with special discounts for estate tax purposes. Eliminating these reasonable discounts will force family business owners to report higher values to the IRS than they could expect to obtain from a buyer, and thereby pay higher taxes at death. Thus, the tax cost of transferring assets from generation to generation will increase.

Valuation discounts for family-held businesses exist in two basic forms: discounts for lack of control and lack of marketability. Under current rules the fair market value of an interest in a family-held business where no current market is available is based on the "willing-buyer/willing-seller" test; this test establishes a value a willing buyer would pay for that portion of a family-held business. In recent court cases challenging valuation discounts for gift and estate taxes the IRS used significantly lower valuations than CPA firms hired by the family-held businesses often resulting in the IRS seeking larger tax collections.

Lack of Control Discount

When an heir receives a portion a family-held business that is a minority ownership stake, that portion of the business can be valued lower than a majority ownership share because a willing buyer would not have control over managerial issues. This lack of control makes the minority interest less valuable to a willing buyer than the majority share.

Lack of Marketability Discount

Lack of marketability is an instance in which the interest in a family-held business is not easily convertible to cash. While lack of control does in some instances create a lack of marketability, there are several other reasons an interest cannot be easily sold that reduce the value of the interest. Any barrier to easy liquidation makes an asset, in this case an interest in a family-held business, less valuable to a willing buyer.

Proposed changes to Section 2704

The proposed rule would disregard any restrictions on liquidation or redemption an heir uses to claim a valuation discount if that restriction either lapses after the transfer or the heir or heir's family has the ability to remove the restriction after the transfer. An heir, under current law, could claim a lack of marketability discount if there is a restriction on sale of the interest, the proposed rule would eliminate that discount if the heir or their family has the ability to remove that restriction. The proposed rule also eliminates lack of control discounts to assignees.

Comments can be submitted via regulations.gov

A public hearing will be held December 1, 2016 at 10 a.m.

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