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Summary of Advantages of
Utilizing Valuation Discounts

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This memorandum discusses the advantages of using gifts of fractional ownership interests in a family limited liability company ("LLC") to defer or reduce gift and estate taxes. A family limited liability company can be used as an estate planning tool to "leverage" gifts to the next generation. The leverage is created by valuation discounts that apply to gifts of interests in a family LLC.

For gift tax purposes, the value used in determining the amount of a gift is fair market value, generally defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. Ownership of an interest in an entity such as a family LLC, whether a majority or minority interest, generally will result in a lower valuation for estate and gift tax purposes than the outright ownership of assets outside of the entity. Lower valuations result because minority interest and lack of marketability valuation discounts are allowed for transfers of interests in closely held corporations and limited partnerships.

A minority interest is any ownership interest in an entity such as a family LLC that lacks voting control over the entity, such that the member has no unilateral power to determine the timing of distributions, to force a liquidation of the LLC, or to control the management of the LLC. A marketability discount generally applies to majority and minority interests in a LLC due to the illiquid nature of such interests. A combined marketability and minority interest discount may approach fifty percent.

The following example illustrates the advantages of utilizing valuation discounts in gifts of Family LLC interests:

Suppose Mom and Dad own real estate worth $1,000,000.00. They wish to make partial gifts of this real estate to their four children to take advantage of the $13,000.00 annual exclusion under Internal Revenue Code § 2503(a). Mom and Dad decide to establish a family LLC to own the real estate. Each receives a 50% interest in the LLC upon contribution of the real estate to the LLC. Mom and Dad are appointed managers, which gives them the power to make all decisions regarding the management and operation of the LLC. After establishing the LLC for substantial business reasons, and after the LLC has been in existence for some time, Mom and Dad make a gift of 19.2% of their interests in the LLC, by giving a 4.8% interest to each of their four children.

Each gift of an interest in the LLC is entitled to a minority interest discount, because each child lacks control of the entity. Each gift is also entitled to a lack of marketability discount because each interest in the LLC is highly illiquid, and no child has the power to liquidate the LLC. Assuming for purposes of this example a total discount of fifty percent, the fair market value of the 4.8% gift made to each child is only $24,000.00, even though 4.8% of the underlying assets in the LLC is $48,000.00. Thus, the gift tax exclusion has been "leveraged" using the LLC because $48,000.00 in underlying asset value has been transferred to each child without gift tax cost and without using any unified credit.

As the real estate owned by the LLC increases in value, such increase in value will be reflected in Mom's and Dad's estates only to the extent of their remaining interest in the LLC. Furthermore, after the gifts Mom and Dad each owns only a 40.4% minority interest in the LLC. Each such interest lacks the power to liquidate the LLC, and would also be entitled to minority interest and lack of marketability discounts. Thus, significant gift and estate tax savings can be achieved by using a family LLC, although at the "cost" to Mom and Dad of foregoing the income that otherwise would have been received on the 19.2% that has been given away to the children.

Because of many recent court cases involving the use of family limited liability companies and family limited partnerships, a careful analysis in each instance is needed before interests in a family entity are gifted. Moreover, in most situations a professional appraisal is needed to value both the company's underlying assets and the fair market value of the interests gifted. The cost of such appraisals must be considered when a decision is make to implement the use of family entities as a part of one's estate plan.

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