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Common Discounts Used in Valuations of Closely Held Businesses

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Whenever valuing a minority ownership, i.e. less than 50% ownership of a closely held business, it is necessary to include discounts to the final valuation to reflect the minority interest and lack of marketability. These discounts, typically used in fair market value calculations, reflect the negative effects of lack of control and inability to sell or liquidate the minority interest at will.

An owner of a less than 5% interest, in any entity, usually will not maintain any substantial control over the organization; especially if another owner maintains a majority interest. Without control of the company, the minority owner cannot control wages, dividends, or other financial policies for the company. Minority interest discounts range from 20% to 40% and applications tend to lean towards 30% to 35%.

Fair Market Value

The fair market value method of valuing an entire interest are often based on comparisons of the market values of recent sales of entire entities or whole pieces of property. There are certain marketability differences between the fair market value of an entire entity and a partial interest in a thinly traded entity that lacks a regularly traded market. For example, an owner of a less than 5% interest in a publicly traded security can know at all times the market value of his or her holdings. They can sell that holding on virtually a moment's notice and receive cash net of brokerage fees within several working days. Liquidating a less than 5% interest of a privately held entity, in comparison, would be a more costly and time consuming process than liquidating stock in publicly traded firms. In addition, an owner of a less than 5% interest cannot convert the underlying assets of the entity into cash without the entire entity selling its assets. As a result, lack of marketability discounts range from 10% to 33% and applications tend to lean towards 20% to 25%.

Lack of Marketability Discounts

These two discounts are usually applied sequentially. A lack of marketability discount is applied whether or not the equity interest is controlling or non-controlling interest. A minority interest discount is applied to the proportionate share of the total estimated value.

Professional business valuators regularly apply these discounts and there are numerous Tax Court cases dealing with the issue of valuation discounts. Business valuations are always subjective and the variables and formulas used in determining an initial value will often include the fair value of the net assets plus intangible assets and consideration of discounts to arrive at the final value.