Fractional Interest Discounting as a Technique to Save Significant Inheritance Taxes

A prior article on the subject of "Gift Taxes" made brief mention of an additional technique, which can often be beneficially applied in implementing an estate plan.

From the prior article all are aware that a regular program of making gifts particularly by well-healed individuals can save a significant amount of Pennsylvania Inheritance Taxes, Federal Estate Taxes and administrative expenses upon ones death. For example, if one were to be in the federal estate tax bracket and die a resident of Pennsylvania, a gift of Eleven Thousand Dollars ($11,000) to a member of the younger generation will typically save perhaps Five Thousand Dollars ($5,000) in Federal Estate Taxes, Pennsylvania Inheritance Taxes, and administrative expenses.

Individual "donors" (those making the gifts) are limited however to making gifts no more than Eleven Thousand Dollars ($11,000) worth of gifts in any calendar year to any one individual. Stated otherwise, Bill Gates could give no more than Eleven Thousand Dollars ($11,000) a year to every resident of China, each and every year but, if he were to make a gift of over Eleven Thousand Dollars ($11,000) to any one person in any one year, he would be required to file a Gift Tax Return.

There is a technique known as "Fractional Interest Discounting" which allows for the gift of a small portion of an asset (a fractional interest) in a way such that the fractional interest is valued less than the "actual interest". How can this be so? It is so because all of the pieces to ownership of assets by themselves are valued at less than the sum of the pieces which by necessity equals the total.

The way it could be best explained is by an example. Assuming Agri-Businessman Farmer Brown owns a One Million Dollar ($1,000,000) piece of real estate. If Farmer Brown were to convey the entire tract of real estate to a son or a daughter, the value of that real estate would be a Million Dollars ($1,000,000). Value is usually determined by an appraisal based upon what a willing Seller would sell a property for to a willing Buyer neither of whom would be under any obligation to consummate the transaction. If Farmer Brown however would instead gift away only a five percent (5%) interest in the Million Dollar ($1,000,000) farm, one might think that five percent (5%) interest would be worth Fifty Thousand Dollars ($50,000). Not so! A five percent (5%) interest in a larger asset is typically valued at significantly less for a number of reasons including:

(a) Lack of marketability – How can the owner of the five percent (5%) interest sell it or turn it into cash if he or she chooses to do so? If they would choose to do so, likely a Buyer would only pay a fraction of the "value."

(b) Lack of Control – Only a five percent (5%) interest when someone else or, a combination of others own the ninety percent (95%) interest creates a lack of control issue thereby making the value less.

For these, and other reasons, appraisers are often able to value the fractional interest at less than the arithmetic percentage of the whole. Typically fractional interest discounts of between fifteen percent (15%) and forty percent (40%) can be invoked.

What is the result of fractional interest discounting? It works this way. If Farmer Brown can give away Eleven Thousand Dollars ($11,000) in value to his son or daughter, if that five percent (5%) piece of the farm could be discounted by thirty five percent (35%), the Fifty Thousand Dollar ($50,000) interest would only be reported for gift tax purposes at Thirty Two Thousand Five Hundred Dollars ($32,500) which would allow that interest to be given within the Eleven Thousand Dollar ($11,000) annual exclusion, over a period of three (3) years (3 x $11,000 = $33,000) and, the balance namely Seventeen Thousand Five Hundred Dollars ($17,500) ends up being transmitted to a member of the younger generation without the payment of any gift tax.

This technique has been used by this author in counseling clients to save a considerable amount of gift and federal estate taxes. In the actual case study, a single elderly individual owned a very valuable piece of land in the most prominent commercial (shopping) district in Lehigh County. That patriarch of the family was willing to make annual exclusion gifts to various family members including children, grandchildren and great-grandchildren. The “student body” of family members totaled approximately thirty (30). Using the annual gift tax exclusion as well as fractional interest discounting, allowed this several Million Dollar worth parcel of real estate to be gifted over a series of years resulting in the payment of zero gift taxes and zero federal estate taxes on this very valuable asset. It was necessary to combine the gifting technique with appropriate trusts for the receivers of the gifts who were under age whereby other senior members of the family were named as trustees to manage the shares for those who had not received their age of majority.

This article was authored by Charles W. Stopp, Senior Partner of Steckel & Stopp Law Firm with offices at Main Street and Walnut Street, Slatington; Schnecksville and Northampton which has been serving the estate and elder law planning needs of the Lehigh Valley areas in excess of fifty-five years.