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The IRS and Family Limited Partnerships

Despite the popularity of family limited partnerships, their use is not without risk. The IRS has scrutinized family limited partnerships that do not appear to have a legitimate business purpose and the current administration has proposed changes that eliminate the valuation discounts for such non-business partnerships. Typical non-business purposes of establishing a family limited partnership can include retention of assets within family, protection of assets from future creditors, control over partnership distributable cash flows, and protection of family assets from failed marriages.

Despite the popularity of family limited partnerships, their use is not without risk

The IRS conceded the use of valuation discounts for minority interests in family limited partnerships with bona fide business purposes in 1993, but retained the right to scrutinize those discounts. As an example, in recent rulings the IRS has ignored the existence of a family limited partnership created just before the general partner's death (see TAM 9736004, 9719006). In the service's opinion, these partnerships were created for the sole purpose of avoiding estate taxes.

In one of the more noteworthy IRS rulings (TAM 9842003), the decedent organized a family limited partnership in June 1995. The partners included the decedent, who contributed $9,900 in exchange for a 99% limited partnership interest, and two of her children, who each contributed $50 in exchange for a 0.5% general partnership interest. Three months later, the decedent transferred $1.8 million in cash and marketable securities to the Partnership. One week prior to her death in October 1995, the decedent transferred two parcels of real estate, including her personal residence, to the partnership in addition to $90,000 in cash. The decedent's total contributions of cash and property to the partnership in the six weeks prior to her death constituted over 98% of the net asset value of the partnership, more than $2.2 million.

On the decedent's federal estate tax return, her limited partnership interest was valued at 60% of the value of the assets she transferred to the partnership in the six-week period prior to her death. The IRS disallowed the 40% discount largely because the decedent's transfer of assets to the partnership was a testamentary transaction, the primary purpose of which was to reduce federal estate taxes. Therefore, any decrease in the value of the assets resulting from the creation of the partnership was disregarded for estate tax valuation purposes.

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Developing Valuation Multiples Using Comparable Public Companies

One of the best benchmarks for determining the value of a closely held company is the value of similar companies which trade on organized exchanges. Reviewing comparable public company pricing is not just educational, it is required. Revenue Ruling 59-60 reads:

> "the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter" (Revenue Ruling 59-60 (1959-I.C.B. 237), Section 4h)

In addition, section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock

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However, the IRS advised that, even if the 40% discount were allowable for estate tax purposes, the decedent should have paid a gift tax on the transfer of assets to the partnership in exchange for her limited partnership interest, since the value of that interest was less than the value of the assets transferred. Reasoning that any transfer to a family member for less than adequate and full consideration in money or money's worth is presumably a gift, the IRS noted that the "Decedent transferred assets worth approximately $2.2 million and after the transfer, held a partnership interest purportedly worth 40% less than the value of the assets she transferred to the partnership. This unequal exchange constitutes a gift for gift tax purposes, unless the transfer can be characterized as a transfer in the ordinary course of business."

The IRS stated that, while the general partners may have had a legitimate business purpose for transferring their assets to the partnership, the decedent, had she been dealing at arm's length, never would have relinquished ownership, control and in the income flow from her assets in exchange for an interest worth 40% less than those assets.

The discounting of minority interests in family limited partnerships has come under the scrutiny of the Clinton administration in its proposals for the year 2000 budget. According to the Treasury Department's Green Book, which includes general explanations of the administration's budget proposals, the budget recommends that Congress eliminate valuation discounts altogether except when active businesses are involved.

Interests in entities would be required to be valued for tax purposes at a proportional share of the net asset value of the entity to the extent that the entity holds non-business assets (i.e. cash, cash equivalents, publicly traded securities, real property) at the time of the gift or death. To the extent the entity conducts an active business, the reasonable working capital needs of the business would be treated as a part of the active business, in other words not subject to the limits on valuation discounts.

If passed, this proposal would be effective for transfers made after the date of enactment. The administration estimates that the change would raise approximately $2 billion over a five-year period. However, similar restrictions have been proposed in the past and have been met with little success in Congress.

Going forward, careful consideration should be given to the establishment of the partnership's purpose, with concentration on the bona fide business reasons for the existence of the partnership, especially in light of increasing scrutiny by the IRS and the current administration. For more information on family limited partnerships, please feel free to give us a call. ◆

Comparable Public Companies

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or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks that are actively traded by the public.

In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded on the over-the-counter market may also be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date.

The procedure used to develop a group of public companies (often referred to as "guideline" companies) includes the following steps:

- The industry or industries in which the Company operates are identified.
- Appropriate Standard Industrial Classification Code(s) (SIC Codes) for the Company are identified and various databases are searched for a group of companies in a line of business similar to that of the subject company. Other possible companies may be discovered in the course of other research.
- Detailed descriptions and business segment data for the potential guideline companies are reviewed to eliminate those whose products or services differ from that of the subject company.
- Companies whose stock is thinly traded are typically eliminated, as such companies' transactions data is less meaningful.
- The remaining companies are further analyzed in terms of operating, financial, geographical, industry, and/or market characteristics to insure that they are reasonable for inclusion in the guideline company group.

The last step in this process is the most subjective. A thorough understanding of the financial standing and the operating performance of the subject company is essential to establishing the parameters by which to screen guideline data. Screens should include revenue mix, market, products, size of company, revenue margins, capital structure, and growth – both historical and estimated. While an optimal guideline group will contain numerous companies, the number of companies included will depend on the similarity to the subject company, trading activity, and the financial information available.

Once this group is identified, critical valuation data about each company can be assembled in a table. This table will include critical balance sheet and income statement data, trading information about the guideline companies, and, of course, an array of valuation multiples implied by the public market pricing.

The most commonly used version of the "guideline company method" develops a price/earnings ratio with which to capitalize net income. Other indicators include the capitalization of pre-tax income, cash flow (various definitions), book value, revenues, or other indicators of value derived from the guideline company group. Earnings multiples developed using the guideline company method are used to capitalize appropriate estimates of earning power for the subject company.

It is often useful to look at many different multiples for the guideline companies, and especially to derive multiples that carry more weight within the industry such as price to funds from operations (for real estate investment trusts), or price per subscriber (for cable television companies). It may be necessary to adjust the multiples implied by the public markets for fundamental differences between the subject company and the guideline companies.

Several factors that give rise to the need for an adjustment are listed below.

1. **Size.** Public guideline companies are generally larger than the private companies most appraisers value.
2. **Growth.** The growth expectations of public companies that appear in many guideline company groups may be considerably higher than the growth expectations for the subject private company.
3. **Access to Capital Markets.** The ability to access the public capital markets to facilitate future growth is often overlooked.
4. **Financial/Operating Strength.** Public companies tend to be better capitalized and have greater depth of management. They also tend to have fewer unfavorable concentrations of products, markets, or customers than the typical closely held business.
5. **Other Specific Factors.** Occasionally, market, company-specific, or industry conditions may be considered by the appraiser.

As you can tell from reading this article, the breadth of the task and the resources required to do a proper guideline search and analysis is among the most challenging aspects of business valuation. If you have questions concerning guideline research or any related valuation issue, please do not hesitate to call. ◆

Case Law Update

Foote v. Commissioner

(T.C. Memo 1999-37,
filed February 5, 1999)

In *Foote*, the court addressed the sole issue of the fair market value of 280,507 shares of Applied Power, Inc. held by the Estate of Dorothy B. Foote after application of an appropriate blockage discount. Table 1 indicates the various values attributed to the shares.

Background. The Estate of Dorothy B. Foote ("the Estate") consisted of 280,507 shares in Applied Power, Inc. ("the Company" or "Applied Power"). Applied Power was established in 1910 and is an international manufacturer and distributor of equipment for motion and position control application for industries like construction, transportation, natural resources, aerospace, and defense. Its stock is traded on the New York Stock Exchange.

At the date of death, November 27, 1993, the management discussion in the Company's 10-Q indicated sales and earnings per share had declined. However, research reports issued by Robert W. Baird & Co. earlier in 1993 indicated the Company was "poised to benefit from an economic recovery in its end markets, but difficult European and Asian markets will likely keep a lid on stock performance until fiscal 1994." In November 1993, Baird issued another note indicating the Company's story was improving, but its earnings were not. Baird was still recommending holding the stock.

Within three months after Mrs. Foote's death, 240,000 shares were liquidated in two transactions through Cantor Fitzgerald & Co. and Jeffries & Co. Table 2 on page 4 indicates the blocks sold and prices.

On Schedule G of its estate tax return, the Estate claimed a blockage discount of 5.24%, yielding a value of $14.333 per share. There was no supporting documentation for this discount attached to the return. In its notice of deficiency, the IRS indicated the appropriate blockage discount was 0.83%, or $15.00 per share.

Fair Market Value. The parties stipulated to a price of $15.125; therefore, the Court was left to decide only the appropriate blockage discount.

The Estate. Petitioner presented expert testimony from Robert E. Kleeman, Jr. of Clifton Gunderson, LLC. His report indicated that a blockage discount of 22.5% was appropriate. He prepared a linear regression analysis of trading volume and prices leading to the valuation date in order to forecast how the block could be sold without depressing the price. His report concluded it was not possible to dispose of the block without depressing the price. His discount represents the conclusion that the stock price would drop $0.09 per day over a 40 day period required to dispose of the Estate's stock. Mr. Kleeman's report also indicated he had reviewed eighteen

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Table 1

	Estate Tax Return	Notice of Deficiency IRS	Petitioner's Expert (Mr. Kleeman)	Respondent's Expert (Mr. Davis)	The Court
Value of Shares	$4,020,600	$4,207,405	$3,287,542	$4,102,415	$4,102,415
Value Per Share	$14.33	$15.00	$11.72	$14.63	$14.63
Blockage Discount	5.24%	0.83%	22.50%	3.30%	3.30%

blockage discount cases that he deemed factually similar. These supported his discount conclusion in that the average of the mean and median discounts of these cases was 22.5%.

IRS. Respondent presented expert testimony from Richard L. Davis, CFA of Southwest Securities, Inc. His report opined that a discount of 3.3% was appropriate. He indicated that ultimately a significant portion of the stock was liquidated within 90 days of the date of death without depressing the price. He cited a number of factors to also support his conclusion. Some of these factors included:

- The block represented only 2.2% of total shares outstanding.
- The block represented the number of shares traded during an average 29 day period for the Company.
- There were no resale restrictions.
- The size of the "float" of the stock (90% of the shares outstanding).
- The earnings forecast for the Company was positive, and the outlook for the economy in general was positive.
- The stock market was stable to moderately rising, and the price performance of the stock compared favorably to the market.

Mr. Davis supported the reasonableness of his conclusion with the observations that large blocks of stock were liquidated with several months of the valuation date with relative ease and no significant effect on the stock price. Therefore, a blockage discount of 3.3% was appropriate.

Table 2

	2/17/94	2/22/94
Shares Sold	200,000	40,000
Reported Price Per Share	$19.00	$19.25
Daily High Price	$19.25	$19.38
Daily Low Price	$19.00	$19.12

The Court. The Court indicated it found Mr. Davis' analysis more reliable than that of Mr. Kleeman and accepted the 3.3% blockage discount indicated in Mr. Davis' report. The Court cited the fact that Mr. Davis' analysis considered appropriate factors in coming to its conclusion such as the size of the block, ownership of other blocks, current and historical trading volumes, related company specific events, and general economic conditions and market trends.

The Court did reject arguments that Mr. Davis' use of subsequent information was inappropriate. The Court indicated that the subsequent sales of a total of 240,000 shares that occurred within three months of the date of death were close enough to be considered helpful comparable sales.

Finally, the Court indicated that the size of the block at issue relative to total shares outstanding, the patterns of trading volume for Applied Power stock, and the fact that the entire block was sold within several months did not support a discount of the magnitude advocated by the Estate.

Conclusion. Appraisers are put in a difficult position when performing a valuation in that they must determine what subsequent information may be acceptable to consider and what may be unacceptable. In the present case, the Estate's appraisal did not consider subsequent information. Unfortunately, the subsequent information made their conclusion seem unreasonable. Clearly, appraisers must be cognizant of subsequent information when performing a valuation, even if the information is not used in preparing the report. ◆

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