

Presentation to the ASA NY Chapter
September 24, 2001

Valuation Issues in Family Limited Partnerships and LLCs. by J.L. Pierson, AM

Note: the estate/gift tax has **NOT** been repealed! Higher 2001-2010 exemptions and thankfully decreasing rates have however been enacted! Will Congress leave this alone between now and 2010? In 2010? The resulting uncertainty and complexity will make advising clients even more difficult ! The need to understand the values is keener than ever.

A. Rationale for holding assets in a partnership or LLC:

1. The senior generation can transfer indirectly interests in family assets without losing control. The senior generation keeps the senior interests and thus controls the cash distributions, if any.
2. Asset protection can be achieved since the best creditors can only obtain a charging order and can not obtain liquidation of the underlying assets.
3. It satisfies the goal of keeping the asset in the family. Typically, other partners can acquire interests from partners willing to match a 3rd party agreed price. Other partnership provisions can prevent the loss of family control over assets because of divorce or insolvency of a partner.
4. FLP can solve the problem of too large an asset to gift covered by the annual exclusion.
5. Economies of scale can result from placing assets which need to be managed in a partnership.
6. Flexibility: entity governance generally rests with GP or managing member only.
7. FLPs are pass-through entities: they file informational return [form 1065] and issue schedule K-1s to partners, who pay their own taxes. FLPs are likewise not subject to franchise and similar taxes. Corporation do pay income tax, resulting in the double taxation of dividends. S-corporation receive treatment akin to FLP but have significant limitations on their owners. LLCs generally have similar advantages as FLPs.
8. The gifting of a junior interest in an FLP may be made at a discount of value due to its lack-of-marketability [LOM] and lack-of-control characteristics. The 2 concepts are reasonably well established, although IRS still fights them. This has become particularly important since the defeat in the courts of the family

NYNJCT-BV.com
203-325-2703 CT

attribution doctrine leading to revenue ruling 93-12, principally after the 1981 Bright tax court case¹.

B. Chapter 14 issues:

Generally, the business appraiser defers to the client's trusts and estates law expert in deciding whether Chapter 14 does/does not apply. The attorney will also help clarify the partnership agreement and state law. In non-lawyer's language:

Chapter 14 was enacted effective in 1991 to address and overturn the results in Estate of Harrison². The concern was about restrictions imposed on corporate interests and rights which were designed to expire upon the taxpayer's death.

Section 2703 addresses provisions in buy/sell related agreements that suppress value. It states that the value of a partnership interest will be determined without regard to:

1. Any option agreement, or other right to acquire or use the interest, at a price less than Fair Market Value.

2. Any restriction on the right to sell or use the interest. However, the section does not apply to any option, agreement or restriction which is a bona fide business arrangement, is not a testamentary device to transfer property to family members of the decedent for less than full consideration, or, at the time of the inception of the restriction, whose terms are comparable to similar arrangements entered into by persons in arms-length transactions.

Section 2704(a) applies to lapses of voting or liquidation rights. Any provision restricting a partner's ability to liquidate or withdraw is not to be considered when valuing the interest.

Facts should of course be carefully analyzed. The restriction can be ignored when the individual who is transferring the interest controls the company, or if the restriction lapses or can be eliminated by amending the partnership agreement. However, if the restriction is more restrictive than that allowed under applicable state law, then the restrictions would be disallowed.

Section 2704(b) applies to restrictions that effectively limit the ability of family owned businesses to liquidate. According to the legislative history, these rules do not affect minority discounts or other discounts available under present law.

Get an opinion to the effect that Chapter 14 does not apply. If not available, qualify the report to the effect that you have assuming that it does not.

C. Selected US Tax Court cases:

¹ Estate of Mary Frances Smith Bright v. United States, 658 F.2d 999 [Fifth Circuit 1981.]

² T.C. memo 1987-8.

J.C. Shepherd 115 T.C. No. 30 October 25, 2000.
Estate of Etta Weinberg T.C. Memo 2000-51, February 15, 2000.
Knight 115 T.C No. 36 November 30, 2000.

D. Market Data:

BV appraisers, of course, defer to the real estate appraisers in determining the fee simple, unencumbered value of the underlying real property. Typically, the BV appraiser will have a disclaimer to the effect that he relied on the real estate appraiser's conclusion.

Very much like the valuer of a closely-held corporate interest will look to publicly traded guideline companies for market support, the FLP interest appraiser will look for what data is available, estimate the if-traded value and apply appropriate LOMD and minority discounts.

Partnership Profiles

Starting in the seventies, syndicators sold limited partnership interests to the investing public representing a share in real property projects. Projects included office building, apartment complexes, industrial or specialized properties. The allure of the investment included the right to claim depreciation [pre-AMT law] and the appreciation potential, with occasional operating income. Some of these partnerships, often sponsored by brokerage or real estate firms, are still with us. Informally, a secondary market developed for these units starting in the early eighties, but the market is still comprised of only a few firms [today exactly 9.] Some of the market makers take positions, most however are simply matching buyers and sellers for a fee. Occasionally, real estate professional investors attempt to take over a partnership by rounding up enough interests to impose their vision. In the latter case, the individual investor wins, because prices go up/discounts go down. Quite a few highly leveraged partnerships with little or no cash return to investors are still with us; these are typically penalized by a heavy discount.

Partnership Profiles, Inc. ["PPI"] has been compiling the actual discounts reflected in trades since 1990. The BV appraiser owes a big debt to PP because trying to analyze the data, if one could obtain it from the market makers, is complex; often it is not what it appears in the entity's SEC filings.

The PPI data is not to be used without caution. First these partnerships are fast disappearing, creating statistical problems [small samples.] During the past several years, liquidity events have been anticipated by many of these sometimes long-suffering investors and the investment horizon has apparently decreased from decades to years. Does the implied horizon fit your subject FLP?

It is difficult at times to segregate the discount into LOMD and minority discount. Unless the partnership suffers financially, most of the discount, in my opinion, is for lack of control. It is

NYNJCT-BV.com
203-325-2703 CT

difficult to relate publicly reporting [but not traded] partnerships with the average one or two properties FLP. Certainly, there is almost always a reason to add discounts for concentration or lack of professional management and other specific risks.

Closed-end Mutual Funds statistics:

Closed-end mutual funds represent another good source of data on minority stakes in entities holding securities since the investor in both cases can not influence the sale of the underlying assets. Data can be collected from The Wall Street Journal, Barron's or Morningstar or closed-endfunds.com. Case law suggests that taking averages does not cut it any more; finding similar funds works reasonably well despite decreasing closed-end funds discounts currently and despite the "star effect" of certain fund managers e.g. Zweig.

Ibbotson data:

Provides the risk premium and beta for the real estate investment trust industry [SIC 6798] and the size risk premium, which is important to real estate FLP/LLCs.

REIT data:

REIT used to disclose their NAV but most have not done so recently, and the tax structure makes it difficult to compare with a typical partnership. Return data is available from www.nareit.org for the industry as a whole and its major classifications.

E. Bibliography:

Bruce A. Johnson and Spencer Jefferies Comprehensive Guide for the Valuation of Family Limited Partnerships Dallas, TX: Partnership Profiles, Inc. 2001.

Jay B. Abrams Quantitative Business Valuation New York, NY: McGraw-Hill 2001 pp.313-353.

Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, D. Keith Wilson Guide to Business Valuations Fort Worth, TX: Practitioners Publishing Company Ninth Edition [February 1999] Chapter 14.

Curtis R. Kimball *Valuing Family Limited Partnerships and Limited Liability Company Interests for Estate Planning Purposes* in Thomas West and Jeffrey Jones, editors Handbook of Business Valuation New York: John Wiley & Sons 2nd Edition 1999. Chapter 37, Pages 502-524.

Charles L. Elliott *The Valuation of Family Limited Partnerships* in Robert F. Reilly and Robert P. Schweih, editors Handbook of Advanced Business Valuation New York, 2000: McGraw Hill. Chapter 8 Pages 155-173.

Z. Christopher Mercer Quantifying Marketability Discounts Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests, Memphis, TN: Peabody Publishing 1997

George B. Hawkins and Michael A. Pashall CCH Business Valuation Guide Chicago, IL: CCH

Incorporated updated periodically Chapter 26 [paragraphs 2601 through 2654.]

Robert E. Dallman Valuation Discounts for FLP's and FLLC's Milwaukee, WI: Reinhart, Boerner, Van Deuren, Norris & Riselbach, S.C. November 11, 2000 Presentation for the Milwaukee Chapter of American Society of Appraisers.

Richard E. Rowlands Unique Issues in Drafting for Family Limited Partnerships Albany, NY: The Rowland & Clark Law Firm, LLC 2001.

F. Examples:

1. Valuation of minority, non-marketable interest in an LLC holding marketable securities, based largely on the Johnson/Jefferies book.
2. Valuation of minority, non-marketable interest in an FLP holding a small shopping mall and development land, mostly based on Partnership Profiles data.

G. Key Issues for Appraisers of Junior FLP or LLC interests:

1. Business Purpose: generally taken care of through a well-written partnership agreement; formalities are also important, if state law not respected, the entire structure becomes void.
2. Contributions: important to understand who funds what, and how cash calls are issued [though generally not to the limited partners.] Understand the tax return.
3. Management prerogatives: generally the general partners/managing members control all policy and execution, while the limited partners have no management role³.
4. Distributions: generally at the discretion of the GP. Has big influence on value.
5. Transferability: generally there will be a right of first refusal running to the partnership or to another partner if a third party makes a bid for an interest. Typically, limited partners may not sell their interests, or at best sell an assignee interest.

³ Even with a super-majority, the owner of units can generally not sell and cannot make anyone a partner. Clearly different from a corporate shareholder, where state law establishes the minimum ownership level above which decisions to sell, merge or liquidate can be made with little added formality subject only to the minority shareholder anti-oppression statutes.

By contrast, even a 99% limited partner in an FLP can not influence liquidation, although he may replace the GP and in certain agreements influence the undisputed right to control the partnership. Without that limited right, the 99% limited partner is no better off than a minority holder in a corporation and valuation should reflect that fact.

6. It is important for the appraiser to understand whether a partner has the right to make the section 754 election. Generally that right is reserved to the GP or the tax matters partner; in some agreement, if a partner requests it, the GP has to follow it⁴.
7. Dissolution/Liquidation: Generally, the agreement states what events cause dissolution; examples would be the end of the term of the partnership, the death, bankruptcy of the GP. In the latter case, the limited partners may have the right to re-constitute without the demised partner. Another event of dissolution is a vote by a certain level of majority of the partners, and any circumstance which under state law would require that the partnership be dissolved.
8. There is no formula which would fit all FLPs/LLCs. Both income and market approaches should be used. The discount rate must be estimated, and tested against the risks of the entity in a universe of competing investments.

⁴ Under Section 754 the transferee or substituted limited partner may write up the basis of the interest to his or her cost, as opposed to the inherited basis or cost basis of the original partner. This is of course useful if the basis of the underlying property is low. However, the election is generally controlled, as all management decisions, by the GP. Partnerships reported in Partnership Profiles generally provide section 754 privileges to their limited investors. Thus an extra discount may be warranted in valuing partnerships which do not.