

Attorney CLE Series



Family Limited Partnerships

**THE REALITIES OF ESTATE PLANNING
WITH FAMILY LIMITED PARTNERSHIPS**

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GYF Business Valuation & Tax Services Groups



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA



Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena. His expertise in specific purpose valuations is well known, and he is a frequent speaker, regionally and nationally, on tax and valuation matters.

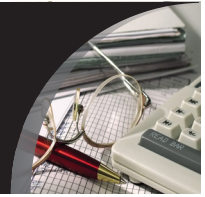
After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

Bob has written numerous articles for several area business publications and professional trade journals. He is a national instructor for both the American Institute of Certified Public Accountants and the National Association of Certified Valuators and Analysts and has served as an adjunct professor for Duquesne University's MBA program.

A member of the American and Pennsylvania Institutes of Certified Public Accountants, Bob previously chaired the Pittsburgh Committee on Taxation. He is also the past chair of the Education Board of the National Association of Certified Valuation Analysts as well as a former member of the organization's Executive Advisory Board, its highest Board.

He is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the Pittsburgh Chapter of the American Society of Appraisers. Bob has held numerous offices and directorships in various regional not-for-profit organizations. He received the 2003 Distinguished Public Service Award from the Pennsylvania Institute of Certified Public Accountants and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two children, Matthew and Alyssa.



Melissa A. Bizyak, CPA/ABV/CFF, CVA



Melissa has practiced in public accounting for over 17 years. She has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Melissa's business valuation experience is very diverse, including valuations of professional practices, as well as companies in the manufacturing, oil and gas and technology industries.

These valuations have been performed for a variety of purposes such as Employee Stock Ownership Plans (ESOPs), marital dissolutions, buy/sell transactions, dissenting shareholder disputes, value enhancement and gift and estate tax purposes.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent more than two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include membership in the National Association of Certified Valuators and Analysts (NACVA) as well as the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA). She serves on the Board of Directors of the Estate Planning Council of Pittsburgh as President and is a member of the Robert Morris University Professional Advisor Council.

Melissa has authored articles appearing in professional publications and has written business valuation course-related materials for NACVA and the AICPA. She serves as a national instructor for NACVA.

Melissa is a graduate of the Leadership Development Initiative, a Leadership Pittsburgh, Inc. program. She serves on the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.



Donald S. Johnston, CPA, MST



Don has spent the majority of his 21-year career serving the tax and consulting needs of privately-held organizations and their owners. He has significant experience handling tax planning and compliance-related issues for all types of entities, including corporations, LLCs and partnerships, and a wide base of clientele, ranging from small start-up organizations in the early stages of development to large, billion-dollar entities in need of technical expertise. Don's broad range of experience encompasses numerous industries, including manufacturing, nuclear energy and mining.

Don also has extensive experience working with distribution entities and has devised tax-savings strategies for income, franchise and other business-related taxes for numerous middle market clients. His skills have been utilized for special projects in various areas of expertise, including: acquisition planning and due diligence, Section 338(h)(10) acquisition work; stock vs. asset sale analyses for acquisition and/or disposition scenarios; development of strategies to reduce state tax obligations of multi-state entities; complex valuation-related issues; and other tax concerns for individual clients. His background allows him to assist individuals and businesses to determine advantageous strategies for mergers, acquisitions and divestitures.

After graduating from Slippery Rock University with a B.S./B.A. in accounting and finance in 1989, Don spent four years with a large international accounting firm in Pittsburgh before joining Grossman Yanak & Ford LLP in 1993. He earned his Masters of Science degree in Taxation from Robert Morris University in 1998.

Don, a Certified Public Accountant, is a member of the American and Pennsylvania Institutes of Certified Public Accountants. He is also a member of the Allegheny Tax Society.

A graduate of the Leadership Pittsburgh program, Don is an active participant in community affairs. He is a passionate advocate for organ and tissue donation and supports the work of the Center for Organ Recovery & Education (CORE), a not-for-profit organ procurement organization. Don formerly served as Treasurer of EveryChild, Inc., a Pittsburgh based not-for-profit organization that serves the foster care and adoption needs of medically fragile children.

Don resides in Franklin Park with his wife, Diana, and their children, Sarah, Scotty and Alaina.



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Please contact Mary Lou Harrison to schedule a date: 412-338-9300 or harrison@gyf.com



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Realities of Estate Planning with Family Limited Partnerships

Introduction

Business entity structures have long been used by taxpayers seeking asset protection and to facilitate strategies designed to alleviate some portion of the economic loss to principal by virtue of income and transfer tax liabilities. Most individuals have observed the advertisements to “hurry up and incorporate” to gain valuable protection and various economic benefits.

Over time, and for a variety of reasons, preference seems to have turned to using entities structured as partnerships. A great deal of the shift has occurred due to changes enacted in the *Tax Reform Act of 1986*, which eliminated the “General Utilities” court decision, thereby invoking an almost incontrovertible, double layer of taxation on corporate income. This development, more than any other, is the catalyst that is responsible for most entities being structured as “pass-through” business entities. A “pass-through” entity, as the name implies, is simply one upon which tax rules impose a single level of taxation on business income. This taxation takes place at the equity owner level, and there is no “second layer” of tax at the business entity level.

The Internal Revenue Code of 1986, as amended (hereafter, “IRC” or “the Code”) provides for two primary business entities that can be described as “pass through” entities. These include partnerships, taxable generally under Subchapter K of the Code, and S corporations, taxed under Subchapter S. Because of numerous statutory requirements and limitations imposed by Subchapter S, and the Treasury regulations issued thereunder, most commentators have come to view partnerships as the vehicle offering the greatest flexibility in planning for both businesses and transfer taxes.

Partnership taxation can be exceedingly complex, and this program is not intended to provide a detailed discussion of the many provisions of the tax law that will be encountered in the creation and operation of a partnership. The program will, however, include a discussion of the general provisions required to enable participants to understand the use of partnerships in transfer tax planning.

Partnerships offer an opportunity to centralize family assets in one vehicle for control and management. Properly structured, they also allow for continuity of business enterprise, limited liability and transferability of ownership. To take full advantage of these beneficial attributes, it is necessary to understand the definition of a partnership, as well as the different forms of partnerships available to those involved in asset protection and transfer tax planning.

Other legal entities are available to accomplish various asset protection and transfer tax goals. The entities that most easily come to mind are the many types of trusts that are available to address a variety of purposes, including those reasons for using partnerships that will be discussed today. Those trusts may be the topic of a future program, but are not part of today’s discussion.



Realities of Estate Planning with Family Limited Partnerships

Chapter I of the program will begin with a cursory discussion of the types of partnerships available for planning purposes and the relevant tax laws and rulings allowing for the effective use of family limited partnerships. We will then turn, in Chapter II, to understanding the mechanics of a family limited partnership and the benefits that might be garnered from the use of such an entity. In the third chapter, focus will turn to recent Internal Revenue Service challenges, focusing primarily on challenges to discounts and those under Chapter 14 of the Internal Revenue Code, titled *Special Valuation Rules*, and IRC section 2036, *Transfers with A Retained Life Interest*.

Chapter IV will address those special matters that must be taken into consideration in valuing partnership interests in family limited partnerships. The fifth chapter will focus on the primary considerations that should be addressed in the determination of discounts for lack of control and lack of marketability. Chapter VI includes a working example to demonstrate how family limited partnerships can, when structured properly, move assets from one generation to another using discounted values. Finally, chapter VII will focus on significant judicial decisions relating to the propriety and acceptance of family limited partnerships over the last decade.

As with all of our programs, it is not our intent to provide all-encompassing materials or to address every nuance relating to the subject matter of that session. Instead, it is our hope that participants will find the program informative, and that it provides a reasonable foundation of knowledge that will prove helpful in your professional legal practices. Should specific facts and circumstance arise in the course of your practice, or if the session materials drive a question that we do not address today, please feel free to contact Bob Grossman or Melissa Bizyak at 412-338-9300.

Thank you for attending and enjoy the program.



Realities of Estate Planning with Family Limited Partnerships

Chapter I – Types of Partnerships & Relevant Tax Guidance at Formation

Partnerships are generally described in the context of two primary structures. The first is a *general partnership*, while the other is a *limited partnership*. In the last two decades, two additional entities have emerged. These include *limited liability partnerships* and *limited liability limited partnerships*. Each of these variations will be briefly addressed in this chapter.

First, however, it is necessary to define the word “partnership.” A “partnership” is a syndicate, group or joint venture, or other unincorporated organization of two or more individuals or entities through which any business, financial operation or venture is carried on, and in which the partners share in the profits and losses.

General Partnership

A general partnership, comprised, of course, of the required two or more partners, is a “pass through” entity, allowing for a single level of taxation and many of the same beneficial attributes that one might find in a limited partnership. However, such entities are generally not utilized in the family asset planning context for a number of reasons.

The most critical reason for foregoing general partnership structures in family asset planning is the lack of limited liability by the general partners. In such an arrangement, the partners are not only at risk for those assets they have invested directly in the partnership in exchange for their capital interests, but they are also personally liable for the debts, financial obligations and other liabilities of the partnership.

Assume an individual contributes \$10,000 to the capital of a partnership in exchange for a general partner interest. Should a future successful litigant obtain a substantial award from the partnership for damages sustained in a lawsuit, and that award exceeds the partnership’s ability to pay, the litigant can, and will, look to the partner’s personal funds to fund the payment of the award. The unknowns of this type of occurrence all but eliminate consideration of general partnerships when the planning centers on family assets.

In addition to the general liability issue, general partners are able to function in the role of management in a general partnership. This ability allows for the control of some, or all, of the management function, including possible cash flow distributions. This control prerequisite that attaches to ownership of a general partnership interest works to defeat the provision of a discount for lack of control.

A fundamental desired function in planning with family limited partnerships is for members of the senior generation to retain control. If partnership units, constituting ownership interest in a general partnership, were transferred to junior generation family members, those junior family members would have a voice in management of the partnership.



Realities of Estate Planning with Family Limited Partnerships

Allowing younger, or less experienced family members to participate in family asset management and other business of the partnership could possibly put the assets and operations at some additional level of risk.

A general partner also may have a right under the state law of organization to withdraw from the partnership and receive financial consideration for his or her interest. If such rights attach to a general partner interest, this capability would infer a lower, or no, discount for lack of marketability.

Limited Partnerships

Use of a limited partnership can alleviate many of the disadvantages associated with the general partnership's entity structure. A limited partnership generally consists of a single general partner and at least one limited partner. In the case of a limited partnership, it is the general partner who assumes the general liability associated with that investment and the partnership. Under most state law organization statutes, the limited partners' exposure to debts, financial obligations and other liabilities of the partnership are limited to those amounts that they have contributed to the partnership in exchange for their partner ownership interest. Personal assets outside the partnership are protected from exposure to loss within the limited partnership by virtue of their limited partner status.

The price to pay for this limited liability protection is the lack of capability to participate in management of the partnership. Limited partners essentially function as "passive" investors who will share in the profits of the partnership, but will share in the losses only to the extent of their capital contributions and previously-taxed income. This lack of participation in management has, of course, the opposite effect on the determination of a potential discount for lack of control that participation in management affords a partner. In this case, greater discounts might be available for lack of control.

In addition to a potentially-larger discount for lack of control, the inability to facilitate control over cash flow distributions can be important in deciding the size of the discount for lack of marketability. Many partnership agreements include provisions limiting transferability of limited partner ownership interests. These agreements are critical elements of underlying information, supporting the determination of discounts for lack of marketability. The fundamental precept of marketing an ownership interest with no control usually results in higher discounts for lack of marketability.

Other Entities as General Partners

The typical limited partnership structure, as set forth above, provides limited partners with liability protection. However, the structure still provides some exposure to unlimited risk with respect to the partnership's debts, financial obligations and other liabilities because of that portion of ownership that is accorded the required general partner.



Realities of Estate Planning with Family Limited Partnerships

To remediate the personal liability exposure associated with the general partner position in a limited partnership, use of another liability-limiting entity is often structured to hold this interest. For example, it is not unusual that a corporation (generally an S corporation), or a limited liability company would hold the general partner ownership interest in the limited partnership.

Other Limited Liability Entities

Limited liability partnerships and *limited liability limited partnerships* are types of limited liability entities that might also address the general liability issue. It is important to understand that these entities are creations of state law and are not addressed in the Internal Revenue Code. Once formed under state law, a default provision and/or “check the box” elections are available under the Code to select the entities’ tax description.

The limited liability partnerships and limited liability limited partnerships provide some protection from the personal liability of the general partner for the debts, financial obligations and other liabilities of the entity. Unfortunately, there are few states remaining that do not recognize the existence of these types of partnerships. In addition, there are structural issues that might arise, as either of these two will still have to be either a general or limited partnership, and state statutes can vary widely. One example is those states that limit the entity’s continuity of life by limiting the period over which they may exist.

Limited liability companies offer yet another form of entity to accomplish many of the objectives noted above. A limited liability company also provides an answer to the continuity of life issue. In those states that have removed mandatory rules relating to continuity of life and have removed the rights of a member to withdraw or, alternatively, provided that a withdrawn member is treated as an assignee of the limited liability company, it is significantly more beneficial to taxpayers seeking valuation discounts as part of the planning strategy.

Historical IRS Challenges to Partnerships

Partnerships have been part of the Internal Revenue Code since its very beginning. The propriety and validity of a partnership has always been at the center of Internal Revenue Service challenges. Early cases looked to state law as evidence that a partnership existed for federal tax purposes. Emphasis then turned to using the family partnership as a device to shift taxable income from higher-tax-rate family members to lower-rate-family members, and, as a result, judicial decisions turned to disregarding the partnerships when the income that was shifted represented remuneration for personal services rendered by one individual and included in another’s income by virtue of that structure. However, partnerships continued to be respected where the shifted income was generated by property or interests in property, so long as the property was shifted to another family member, and, the original family member retained control over the property.



Realities of Estate Planning with Family Limited Partnerships

To combat the income shifts provided by forming a partnership, the validity of the partnership itself, for federal income tax purposes, came under constant attack. The focal point of many of the attacks centered on whether the partnership interests in the partnership were acquired in exchange for “original” capital or “vital” services, thereby suggesting that partnership interest acquired in exchange for property acquired by gift, or if the partnership interest, itself, was acquired by gift should and would **NOT** be recognized. The ultimate resolution came with Congressional approval of legislation and eventual codification in IRS section 704(e).

Section 704(e) provides that a person will be recognized as a partner for federal tax purposes **IF** he or she owns a capital interest in a partnership where capital is a material factor in the production of income, whether or not the partnership interest is acquired by purchase or gift from any other person. Moreover, with some exceptions, this provision allows that the income allocable to the donee partner under the partnership will be includible in his or her taxable income.

It is important to understand that the interest in the partnership held by the donee must have been acquired in a bona fide transaction. If not, the transfer will be deemed a tax avoidance transaction, and it will not be respected for federal tax purposes. This determination is made as a result of applying an objective test set forth in the Treasury regulations under IRC section 704(e).

Although the Treasury regulations under IRC section 704(e) require attention when forming a family partnership, in most instances this test is not a primary consideration, as most family limited partnerships are not set up to shift income to different family members but, rather, to shift wealth and, in many circumstances, future wealth. Moreover, failure to meet the test should not interfere with the wealth transfer strategy, as IRC section 704(e) is an income tax provision and does not govern transfer tax. State law validation of partner status should carry the day at the death of the donor. However, retention of rights in the transferred property should always be carefully assessed in any wealth-shift planning, as other Code provisions relating to transfer tax, such as IRC section 2036 (discussed later in these materials), could prevail to undermine the transfer.

Family Limited Partnerships and Valuation Discounts

Other relevant guidance that applies specifically to the use of family limited partnerships in the development of transfer tax planning strategies centers primarily on issues related to valuation. Most important is the “standard of value” required for federal and state transfer tax planning and compliance. For these purposes, that standard is fair market value, defined as,

“the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is under no compulsion to sell, both parties having reasonable knowledge of relevant facts.”



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Court decisions often add the requirement that the “hypothetical” buyer and seller are assumed to be able, as well as willing, to participate in the trade and that, in addition to being well-informed about the property, they are knowledgeable of the market in which the trade would occur.

The fundamental precept of this definition is that the market, and conditions in the market, drives value for any asset. To that end, in determining value for transfer tax planning purposes, it is necessary to consider all attributes of the underlying property that would be considered by market players for the property.

In the construct of a determining value for an ownership interest in a partnership, any number of considerations could, and will, come into play. However, the attributes and risks not encompassed in the partnership’s operations or asset base, i.e., the activities of the partnership, often fall to two primary areas of risk. These include the attribute of control, or the lack thereof, and the attribute of marketability, or the lack thereof.

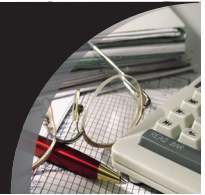
The primary adjustment mechanism to modify value for those partnerships lacking in these attributes are the discount for lack of control and the discount for lack of marketability.

Discounts for lack of control, often referred to as minority discounts, provide one of the most significant benefits of planning with a family limited partnership. By virtue of the “limited” management participation requirements under most state laws, a limited partner interest lacks the ability to mitigate investment risk through control perquisites. As a result, the very serious risk of “non control” is present in these interests and must be accounted for in determining value.

Keep in mind that these attributes and corresponding discounts would also be available to planners using a general partnership structure, or a corporate structure to transfer fractional ownership interests that did not carry with them control features. Usually, these minority interest transfers are used for transferring going concern entities that are separate and apart from entities set up exclusively to garner transfer tax advantages. Again, due to general liability considerations, general partnerships are rarely encountered in business planning.

IRS Guidance to Applying Discounts

The Internal Revenue Service has a long history of challenging discounts for lack of control when there is, ultimately, family control over an entity’s assets and operations. The discount was deemed inappropriate due to family attribution. In other words, where a father remained as the controlling partner and fractional non-controlling interests were transferred to his children, all were deemed by the Internal Revenue Service to hold their direct ownership interest, as well as an indirect interest equal to that held by their father and siblings. Thus, all partners were assumed to hold 100% of the entity, either directly, or indirectly through attribution. The holding of a 100% interest equates to perfect control, so no discount for a lack of control was warranted.



Realities of Estate Planning with Family Limited Partnerships

This position was set out in Revenue Ruling 81-253, 1981-2 C.B.187. Throughout the 1980s, the issues were contested regularly, and more importantly, successfully, by taxpayers. As a result, in 1987, Congress looked to disallow the discounts by providing a legislative response. That provision ultimately failed, and use of the discounts continued. In 1993, the Internal Revenue Service issued Revenue Ruling 93-12, 1993-1 C.B.202. This ruling serves as the very foundation for the current family limited partnership planning boom noted over the last two decades.

Revenue Ruling 93-12 is important, in that it allows that the discount for lack of control will not be disallowed simply by virtue of family ownership. It does not guarantee a discount, as discounts are fundamental questions of fact. However, the release of this ruling facilitated a “run” on these vehicles as family limited partnerships suddenly became in vogue.

Noting that the transfer tax planning community was jumping on the Revenue Ruling 93-12 bandwagon in droves, the Internal Revenue Service tried to take back some of the magnanimous tax advantages the ruling had inadvertently provided. In Technical Advice Memorandum (TAM) 9436005, the concept of “swing vote” was introduced. Under this principle, the Service determined that a swing vote “premium” was applicable when valuing an equity ownership interest transferred to a family member if that interest enabled the holder to join with another interest holder to exert some level of control.

By way of example, assume two identical enterprises. The first has a capital structure comprised of fifty (50) 2% ownership interests. The second has a capital structure comprised of two (2) 49% ownership interests and a single 2% interest. It is easy to understand, in looking at this example, the concept of swing vote and the reasons why the 2% interest in the latter structure carries less investment risk and more value than the former.

Finally, discounts for lack of marketability, addressing a risk separate and apart from that risk compensated for by the application of the discount for lack of control, must be applied if there is an inability to easily convert the equity ownership interest into money. The lack of marketability presents a substantial investment risk and always serves to reduce value. As such, it is very often part of the discounting process undertaken in assignments related to family partnership planning, as transfer restrictions are always present (or should be) in well-crafted partnership agreements.

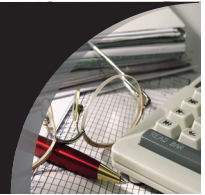
Note that while this program is not a program on discounts, specifically, it is important to understand that the Internal Revenue Service is very concerned about the applicability and the size of these discounts as they are applied in specific circumstances. There is no preset range of discounts, and the process of properly determining the appropriate discounts can be an arduous undertaking. Very often subject to successful challenge by the Internal Revenue Service, obtaining maximum transfer tax benefits requires an understanding of all literature related to the determination of discounts and the progression of these challenges, as well as where the Internal Revenue Service is focusing at all times.



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As an example of the focus by the government, an internal publication titled, IRS Job Aid on Discounts for Lack of Marketability was leaked to the public in the summer of 2011. At 107 pages, this document provides a flavor of what the Service is looking to in assessing the propriety of these discounts.

Numerous other provisions within Subchapter K, Partnerships, as well as other parts of the Internal Revenue Code must be considered in conjunction with partnership planning. However, those primary items noted in this chapter are intended to cover the most salient issues concerning the use of partnerships in the context of transfer tax planning.



Realities of Estate Planning with Family Limited Partnerships

Chapter II – Mechanics of Use and Benefits of Planning with FLPs

The decision to utilize a family limited partnership in conjunction with transfer tax planning strategies will be predicated upon specific facts and circumstances associated with each taxpayer's situation. However, understanding the advantages and limitations afforded by the use of these structures will better enable the practitioner to advise his or her clients when situations arise that call for the incorporation of such entities into an overall estate plan.

Benefits of Family Limited Partnerships

As might be surmised from the previous chapter, the most significant advantage of the family limited partnership, as an estate planning vehicle, is the ability to leverage the annual gift tax exclusion amount, as well as lifetime giving exclusion. Currently capped at \$13,000 per year and \$5,000,000, respectively, use of a family limited partnership can work to expand the amounts transferable under these thresholds by applying the discounts for lack of control and lack of marketability.

In other words, assuming a discount for lack of control at 25% and a discount for lack of marketability at 20%, yields an overall discount of 40%. Using these numbers as an example, the application of the discounts, in effect, could provide a transfer of property having a "pre-discount" value of nearly \$8,400,000 with no transfer tax. At the current highest estate tax rate of 35%, the savings is substantial. Note that while the current lifetime exclusion amount is \$5,000,000, most commentators look for Congress to have the amount significantly reduced for 2013 and beyond.

To understand how the strategy enables one to significantly reduce value via discounts, it is important to understand the mechanics of the partnership. The asset ultimately being transferred via lifetime giving is the partnership interest. Almost always, these interests are the limited partner ownership interests.

A family limited partnership is created by transferring assets to a newly-formed limited partnership. Such contributions to capital, if done properly, can be accomplished without the imposition of tax on either the transferor or the transferee partnership. Note, however, that partnership taxation can be very complex, and numerous rules intended to prevent abuses must be considered in conjunction with setting up a limited partnership.

Generally, the most desirable properties to contribute to the limited partnership are those that will likely see significant appreciation over the planning period. If the contributed property appreciates as expected, the transferor will not only reap the lower transfer tax obligations generated by the use of discounts at the point of the initial transfer, but also all of the appreciation occurring post-transfer will escape transfer taxation at the death of the transferor, as that value will have accrued outside his or her estate.



Realities of Estate Planning with Family Limited Partnerships

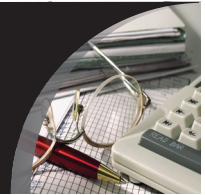
Due to the movement of the value appreciation outside the transferor's estate, it is not unusual to see real property serve as the transferred property in family limited partnerships. Other property commonly transferred includes appreciating financial securities, and more recently, oil and natural gas mineral rights. The most successful family limited partnership transactions are those that experience the greatest post-transfer appreciation. Valuation discounts at inception are helpful but not determinative of transaction planning success.

Another substantial benefit offered by setting up a family limited partnership is retention of control over transferred assets. While retaining certain rights in the property that is transferred is subject to challenge under the Internal Revenue Code (discussed in Chapter III of these materials), the family limited partnership structure can allow for significant control over the underlying assets and the income that those assets generate. This control is accomplished via the role that senior generation transferors hold as general partners. As all management decision-making rests with the general partners, certain controls over the transferred assets are permissible within the constraints of the laws of the state under which the partnership is organized.

Control over the management of the partnership, and through that management, control over the assets, allows senior generation family members to move appreciating assets out of their estates, while ensuring that the steps are taken to ensure that those assets are preserved and not dissipated through poor asset management.

Other advantages commonly associated with the creation and maintenance of family limited partnerships include:

- Ease of amendment – Compared to many other estate planning vehicles, such as trusts and other entity structures, most state laws are relatively more liberal in allowing family limited partnership agreements to be amended.
- Protection from creditors – An aside in many family limited partnership planning strategies is the goal of protecting assets in certain instances from creditors. Creditor protection strategies are beyond the scope of this program, but should be an important consideration in all family estates comprised of significant assets.
- Annual gift giving – In many instances, there is an ease of giving additional partnership interests to meet the annual gift tax exclusion versus gifting other assets in the senior generations' assets portfolio. It is quite common that family limited partnerships with many junior generation limited partners or a growing number of new partners (through births, marriages, etc.) have a continuing transfer of interests through a period of many years, thereby changing the capital structures as often as annually.
- Simplicity of ownership – Though family limited partnerships are not without complex issues, the entity can offer less-stringent rules than those associated with many kinds of alternative entities, especially trusts.



Realities of Estate Planning with Family Limited Partnerships

While family limited partnerships offer substantial advantages over other forms of transfer tax planning alternatives, there are some disadvantages, as well, that must be considered early on to ensure that this concept is right for the family. The most important disadvantages are as follows:

- Cost – Setting up a family limited partnership requires a substantial effort by legal advisors, as well as the use of business valuers. The business valuation must constitute a “qualified appraisal” under the Internal Revenue Code and, in addition to being required for the initial partnership interest transfers, will likely be required each time future transfers are made. The use of a family limited partnership will require professional fees to meet annual tax compliance requirements, as well.
- Loss of IRC Section 1014 basis step-up – A significant trade-off with the use of a family limited partnership is the loss of a property basis step-up available for assets transferred at death. While partnership taxation principles allow for transfers of property in exchange for the capital interests at no gain or loss to the transferor, the corresponding treatment requires a carryover basis in those assets in the partnership. As such, the transfer tax advantages of a family limited partnership have to be considered against the possible higher income tax costs associated with forgoing the basis step-up.
- Investment company characterization – An important exception to the tax-free treatment usually afforded transfers of property to partnerships in exchange for partnership capital interests is Internal Revenue Code section 721(b), which addresses transactions designed to avoid income taxation on the transfers of marketable securities that are intended to diversify the portfolio without the generation of taxable gain. Essentially, the provision requires that if the partnership were classified as an investment company under Internal Revenue Code section 351 (if it were a corporation), and the portfolio is diversified, gain will be recognized on the transfer to the limited partnership.
- Integrity challenges – As noted earlier in these materials, care must be taken to ensure that the junior generation limited partners in the partnership have bona fide capital interest so that their interest will be respected for federal income tax purposes.

Mechanics of a Family Limited Partnership

Mechanically, a family limited partnership is a relatively simple device. However, as noted earlier, and as will be observed in the balance of the materials, complexities abound, which require careful analysis and focus to allow for planning and implementation that will hold up to challenge from the Internal Revenue Service.



Realities of Estate Planning with Family Limited Partnerships

In contemplation of moving forward with the formation and execution of a family limited partnership, consideration must be given to the particular assets that will be transferred to the partnership. Again, it is most beneficial to consider those assets that are expected to appreciate over time, as these assets will then leverage the transfer tax benefits of having those assets held by the partnership.

A key consideration in the selection of assets will be the value of those assets expected to be transferred. As such, it is not unusual at this point that appraisals of real property and other collectible assets will be required. For publicly-traded securities and financial instruments, value can be determined from available financial reporting services and publications. If the assets to be transferred include equity interests in privately-held operating enterprises, it will be necessary to have those entities valued, as well.

The next steps will be to form the partnership, create the partnership agreement and register the limited partnership. This is a process requiring careful focus and attention from legal advisors and is beyond the expertise of the authors of these materials. It should be noted that many of the various provisions in the partnership agreement will have an influence in the applicability and level of discounts. Given this influence, it may be worthwhile to have business valuers review the agreement prior to finalization to enable all parties to understand which of the provisions will affect the final valuation, and whether the influence will result in higher or lower discounts.

It should be noted that the senior generation will likely hold the general partner ownership interests in most family limited partnerships. To address concerns over the exposure of remaining senior generation family assets to general liabilities of the partnership, a newly created liability-limiting organization is very often created to hold the general partner ownership interest.

In most cases, the general partner organization is a limited liability company, but in certain instances corporations can be used. It is important to note, that if using a corporation, an S election converting the corporation to a pass-through business entity is desirable. Limited liability companies serving as general partners in a family limited partnership are usually taxed as partnerships under default rules of the Internal Revenue Code, if both parents are involved in the family limited partnership.

The initial contribution to the limited partnership is accomplished by providing capital to the general partner entity in exchange for its capital ownership interests and through the contribution of assets to the partnership for all of the limited partner ownership interests. The general partner entity (limited liability company or S corporation) then contributes capital to the limited partnership in exchange for its general partner ownership interests.

The next step in the process is valuation of the limited partner ownership interests, with the inclusion of discounts for lack of control and lack of marketability. This valuation is in addition to any valuation or appraisals of the



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underlying assets undertaken earlier in the process. The conclusions of value set forth in this valuation will set the course for how many limited partner ownership interests will be transferred in accordance with the planning strategy developed by legal counsel.

The final step in the process is to prepare gift tax and state transfer tax returns, if necessary, to comply with tax authority filing requirements.

While family limited partnerships are generally easy to understand, and the benefits associated with the use of these entities can prove very meaningful, it is important that users of these planning devices understand that the Internal Revenue Service has focused substantial resources in this area and is very good at challenging the strategies on a number of key issues. These issues are very significant and will be discussed in the next chapter of these materials. It cannot be stressed enough that an understanding of the advantages and disadvantages of using family limited partnerships, as well as a working knowledge of the mechanics of the strategy, must be accompanied by a thorough understanding of the different avenues of attack put forward by the Internal Revenue Service over the last decade to undermine this planning.



Realities of Estate Planning with Family Limited Partnerships

Chapter III – IRS Battlegrounds

The Internal Revenue Service continues to challenge the use of family limited partnerships on a number of fronts. Obviously, as the taxpayer community benefits from the use of these vehicles to reduce estate tax, the Treasury Department loses those taxes that they have saved. Historically, the primary attacks from the Internal Revenue Service focused on formation issues, and the propriety of discounts and the levels at which those discounts were applied to the transferred interests. However, for over a decade, the Service has expanded its attacks to include more sophisticated provisions of the Internal Revenue Code, including IRC section 2036(a), dealing with transfers of property with a retained life estate; IRC section 2701, containing special valuation rules for transfers of certain interests in corporations or partnerships; IRC section 2703, detailing circumstances where the Internal Revenue Service will disregard certain rights and restrictions in the determination of value; and finally, IRC section 2704, addressing the treatment of certain lapsing rights and restrictions. The last three Internal Revenue Code provisions listed, along with IRC section 2702, dealing with transfers of interests in trusts, are commonly referred to as the “Chapter 14 rules.” Logically, the chapter title is *Special Valuation Rules*.

Unfortunately, it is impossible to address those matters, with which advisors recommending the use of family limited partnerships must be familiar, without referencing Internal Revenue Code statutes. A great deal of the understanding that the practitioner community has developed over the last two decades (since the release of Revenue Ruling 93-12) has come from studying the many cases that have been decided in the Courts and rulings released by the Internal Revenue Service. The cases that move to this level are, of course, statute-sensitive. Thus, it is critical that practitioners become familiar and fully understand these provisions and the issues they are designed to address.

Discount Challenges

In the case of a limited partnership, valuation issues will differ for general and limited partnership ownership interests. The primary factor in this matter will center on control, or rather, the degree of control inherent in that partner’s ownership interest. Under state law, the partner whose only ownership interest is a limited interest will have no voice in management and no control over management of the partnership’s affairs. This is true, even if the limited partner holds all of the limited partner ownership interests in a limited partnership that has 99% limited ownership and 1% general ownership.

There are organization provisions that allow a certain percentage of the limited ownership to remove the general partner. As such, understanding the statutory rules, as well as any similar language in the partnership agreement, will allow for a more accurate determination of any required discounts.



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In addition to these limitations on participation in management, limited partners' rights can vary under state law as to when they might redeem their interest in the partnership. Generally, limited partners may be required to wait until the term of the limited partnership ends, as set forth in the certificate of limited partnership. The term set in the certificate of limited partnership affects both the discount for lack of control and the discount for lack of marketability. Some states (Delaware, for example) do not allow a limited partner to withdraw from a limited partnership.

Restrictions, such as redemption limitations, can be included in the determination of value. In a 1999 Tax Court decision later affirmed by the Fifth Circuit, *Kerr v. Comr.*, 113 T.C.449 (1999) aff'd, 292 F.3d 490 (Fifth Cir. 2002), the court held that restrictions on liquidation in the partnership agreement should be taken into account when valuing family limited partner interests. The important fact in *Kerr*, leading the court to this decision, was that the liquidation provisions in the agreement were no more restrictive than the state law restrictions.

A general partner, on the other hand, may be able to have his or her interest redeemed by the partnership at any time. Often these redemption provisions are accompanied by a provision allowing the partnership a penalty for premature withdrawal. In the valuation of these general partner interests, the early withdrawal penalties may constitute an applicable restriction under IRC section 2704(b), discussed later in this chapter. If such is the case, the provision will be disregarded in determining value.

Another classification of ownership interest that requires special consideration is assignee interests. These interests are valued differently from both limited and general interests. This is because most states have limited partnership statutes by which an assignee can become a partner only if the partner making the assignment of the interest has the right, under the partnership agreement, to make the assignee a partner, or all of the other partners consent. This is so, even though there are generally no limitations on limited partners assigning their partnership interest.

Many partnership agreements provide for a group of "permitted assignees," whereby transfer to members of this group allows for movement of the limited partner interests without first having to subject the transfer to a right of first refusal or purchase option available to other partners. To become a partner, the assignee generally must sign a joinder to accept the terms of the partnership agreement. Failure to execute this joinder, in effect, puts the assignee interest in a lower position, in all rights, than a limited partner interest. As such, assignee status will equate to higher discounts and lower values.

Relevant Cases and Rulings Involving IRS Attacks on Discounts

Attacks on the applicability of discounts and the size of those discounts have been part of the Internal Revenue Service's examination agenda since the release of Revenue Ruling 93-12. Three prominent cases in the early 2000s established the Service's premises for attacking valuations discounts.



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- McCord v. Comr., 120 T.C. 358 (2003), rev'd and rem'd, 461 F.3d 614 (5th Cir., 2006) – In this case 65% of the partnership assets were comprised of marketable securities, 30% constituted interests in real estate partnerships, and 5% consisted of oil and gas interests and direct real estate holdings.

The McCords filed a gift tax return reporting the value of the gift. That value was determined in an Assignment Agreement, the intent of which was to provide a valuation formula that would “cap” the gift tax exposure. A portion of the transferred limited partnership interests went to the donors’ children, and the balance went to charity. Numerically, the senior generation donors transferred 82% of their limited partnership interests. The first \$6.9 million “worth” of units went to the non-charity donees (the children).

In this case, the Tax Court decided against the validity of the Assignment Agreements and determined the value of the gifts based on the valuation reports and oral testimony of experts. The case represented the first serious challenge to the validity of using traditional methodologies, especially the pre-IPO studies, to determine discounts for lack of marketability.

Ultimately, the Court looked to the underlying assets to determine the discount for lack of control. It concluded that a 15% minority discount was the proper level of discount, based upon a weighted average of minority interest discount factors considered for each type of investment held by the partnership. The court also allowed a 20% discount for lack of marketability, applying this discount as an entity-wide value modification, as opposed to applying it by asset type.

The effect of the Assignment Agreement was to fix the gift tax exposure to the \$6.9 million. It really did not matter exactly what the value actually was, as any amount above and beyond the \$6.9 million was intended to go to charity.

In overturning the Tax Court, the Fifth Circuit concluded that the Tax Court committed reversible errors in developing its own methods of valuing the gifts. On appeal every issue argued in Tax Court was overturned. The valuation methodologies were not discussed on appeal as they were irrelevant upon acceptance of the value formula set forth in the Assignment Agreement.

- Lappo v. Comr., T.C. Memo 2003-258 – In *Lappo* the issue of valuation was again front and center. In this family limited partnership, all parties agreed that the value of the partnership should be based on the fair market value of the underlying assets with a downward modification for lack of control and lack of marketability. The issue in the case centered on the size of the discounts and the methodologies under which the discounts were to be determined.

The Tax Court again based its determination of the discount for lack of control on a weighted average of the discounts determined for each asset class. In this case, the Court found for an 8.5% minority discount associated with the marketable securities and a 19% minority discount for the partnership’s holdings in real estate investment trusts. Weighting the two and rounding, the Court found for an overall discount for lack of control at 15%.



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The discount for lack of marketability was less scientific, in that the Court simply averaged two studies cited by the government's expert to obtain an initial lack of marketability discount at 21%. The Court then increased the discount by three points, to 24%, to account for additional marketability risks specific to the partnership.

- *Peracchio v. Comr.*, T.C. Memo 2003-280 – In this case the Court once again addressed a family limited partnership whose assets were comprised of cash and marketable securities. The Tax Court applied a minority discount of 6% and a lack of marketability discount at 25%.

Once again, the Court looked to the underlying assets to develop its minority discount. It based the asset class “discount” determinations on the expert witness opinions and the Lipper table, using a low discount of 2% applied to cash and money market funds, to a high of 9.6% for domestic equity funds and 13.8% for foreign equities. The weighted average of all six asset classes was 6%.

The commentary supporting the discount for lack of marketability was more sparse but was based on the evidence submitted.

These three cases form the foundation for future cases such as *Kelly Est. v. Comr.*, T.C. Memo 2005-235 and *Astleford v. Comr.*, T.C. Memo 2008-128, as well as many others that have been decided since the early 2000s. Suffice to say that the issue of discounts as they apply to valuations of family limited partnerships is not a settled matter. However, due to the success of the Internal Revenue Service in challenging expert valuation discounts, and the many court decisions that have transformed the process of determining discounts over the last decade or so, there are certain takeaways that advisors should understand in planning with family limited partnerships. These include the following:

- Discounts for lack of control are best calculated on asset categories, thereby “customizing” the discounts to the underlying asset classes.
- Discounts attributable to higher-quality and less-risky investments, such as cash, money market funds, etc., will yield a lower discount for lack of control than those associated with investments in higher-risk investments such as operating companies and real estate.
- Discounts for lack of marketability are receiving more attention than ever before. Traditional models for determining discounts for lack of marketability have been challenged regularly in the courts and with some success. Discounts for lack of marketability based primarily on the pre-IPO studies will no longer stand up under Internal Revenue Service scrutiny.
- Developing discounts for lack of control and lack of marketability requires more careful drilling into available data to identify entities that are the same or similar to the subject partnership. Simple benchmark ranges of discounts will no longer prevail under challenge.
- The overall levels of discounts being accepted by the Internal Revenue Service have been moving progressively lower over the last decade and a half.



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The answer to defending discount levels in business valuation reports for family limited partnerships lies with undertaking significantly more research than in the past and ensuring that the research confirms a relationship between the independent data and the subject partner ownership interest under valuation. It is clear from observing the cases listed herein, as well as other developments in the Internal Revenue Service's Valuation and Engineering Group that they are seeking more substance behind the numbers and a better relationship between the numbers and the subject.

The Chapter 14 Battleground

Chapter 14 of the Internal Revenue Code was enacted in 1990 as part of the *Omnibus Budget Reconciliation Act of 1990* to circumvent and prevent various “estate freeze” techniques in the family context.

The “willing buyer-willing seller” test previously discussed in these materials assumes that if the willing seller retains an interest in the transferred property, that he or she will exercise those rights in a manner that leads to maximizing the value of their retained interest. IRC Chapter 14 operates in a contrasting format. The assumption under these provisions is that the senior generation family member who has transferred property to the junior generation family member will not exercise the retained rights if the inaction would be advantageous to the junior generation family member.

The Chapter 14 arguments and challenges to the use of family limited partnerships are somewhat more complex and require an intimate understanding of the workings of these provision. Codified in IRC sections 2701-2704, and titled, *Special Valuation Rules*, the sections play an important role in the organization and operation of family limited partnerships. Thus, the rules serve to identify a set of specific transfers between family members, and within those specified transfers, any retained rights other than those where the value can be objectively determined, will be deemed to have no value.

IRC Section 2701

This section of the Code provides special valuation rules to determine the dollar value of a gift when an individual transfers an equity ownership interest in a partnership (or corporation) to a member of that individual's family. The general rule states that the value of any gift determined under this section will disregard the value of any “applicable retained interest,” unless the right consists of the receipt of “qualified payments.”

Stated another way, this section of the Internal Revenue Code applies if a person transfers an “interest” in a partnership to, or for the benefit of a family member, and the transferor, or an “applicable family member,” retains an interest in the same partnership. The mechanics of IRC section 2701 work to limit the gift value of any partnership interest that might be retained by the transferor partner, other than a distribution right that consists of a right to receive a “qualified payment,” to zero. A qualified payment is a fixed-rate preferred payment.



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IRC section 2701(c)(3)(A) provides a special valuation rule for valuing the right to receive a qualified payment in conjunction with an extraordinary payment right.

IRC Section 2702

This section of the Internal Revenue Code, titled, *Special Valuation Rules in Case of Transfers of Interests in Trusts*, is not directly applicable to this program's discussion on family limited partnerships and is beyond the scope of this program.

IRC Section 2703

This section of the Code is titled, *Certain Rights and Restrictions Disregarded*, and provides that, for purposes of estate, gift and generation-skipping transfer tax, the value of property is determined without regard to any option, agreement or other restriction on the right to sell or use such property.

IRC section 2703(b) goes on to provide a level of relief to the general provision by noting that the rule will not apply to any option, agreement, right or restriction that:

- Is a bona fide business arrangement
- Is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth
- Has terms that are comparable to similar arrangements entered into by persons in an arm's-length transaction

Note that to take benefit of the exceptions provided by IRC section 2703(b), it is necessary for the option, agreement, right or restriction to meet all three tests.

IRS Rulings Under Section 2703

IRC section 2703 is used regularly by the Internal Revenue Service in its attacks against family limited partnerships. Often, the section is used in conjunction with IRC section 2704.

The Internal Revenue Service began its attacks against the use of family limited partnerships in 1997 with the release of Technical Advice Memorandum (TAM) 9719006. The facts analyzed in this TAM include the following:

- Decedent held assets in a revocable trust. At death, the assets were divided equally between son and daughter. Because the trust was revocable, assets were included in her estate.
- Decedent was also a beneficiary of a marital trust, created by predeceased husband's will and giving decedent an income interest for life and testamentary general power of appointment over the trust corpus. The assets in



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this trust were also divided equally between son and daughter at decedent's death. These assets were includible in decedent's estate, as well, due to the general power of appointment.

- A family limited partnership was formed two days before decedent's death when she had been terminally ill and removed from life support. Son and daughter each contributed \$33,048 in cash to the partnership in exchange for a 1% general partner interest. The marital trust transferred approximately \$1,707,697 in exchange for an 82.187% limited partner interest. The revocable trust contributed property worth about \$551,446 in exchange for a 15.81% limited interest.
- Immediately after formation of the partnership, the marital trust transferred two 30% limited partnership interests, one each to son and daughter, in exchange for \$10,000 cash and a 30-year promissory note from each with a face amount of \$486,000.
- The notes were reflected on the estate tax return at \$285,414, inclusive of a discount at 40%.
- The partnership interest retained by the trusts at the time of decedent's death were valued at approximately 70% of the value of the underlying assets, reflecting a 30% discount.
- Outcome as listed in the TAM – Assets having a value of \$2,259,144 two days before decedent's death had a value of \$1,177,013 at her death.

The Internal Revenue Service argued this case on two fronts. First, as the formation of the partnership and the transfer of the partnership interest occurred so close together in time, the two transactions should be treated as a single testamentary transfer. Therefore, the partnership should be treated as a sham.

The alternative position of the Internal Revenue Service was to apply IRC section 2703 to the transaction. The Service took the position that what the children really received under the transaction were all of the underlying assets, taken subject to the partnership agreement. The partnership agreement was found to be a restriction, as that term is defined under IRC section 2703, and any reduction in value caused by the partnership agreement was to be disregarded unless a bona fide business arrangement exception applied under IRC section 2703(b).

The Service goes on to note in the TAM that even if the steps were not collapsed and the partnership interests, rather than the underlying assets, were treated as the subject of the transfers, IRC section 2703 would still apply because Treasury regulation 25.2703-1(a)(3) provides that the restriction can be either contained in the partnership agreement or the capital structure of the partnership.

The Internal Revenue Service issued a number of subsequent TAMs, ruling similarly on what they have decided are sham transactions. IRS TAMs 9730004, 9725002 and 9723009 offer similar fact patterns, analysis and application of the sham transaction doctrine, as well as IRS section 2703. A similar ruling, Private Letter Ruling 9736004, addresses the same rules, as they apply to limited liability companies, with similar results.



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Judicial Decisions Under Section 2703

The Internal Revenue Service has not been as successful with IRC section 2703 arguments in court. As an example, in a Tax Court decision, *Strangi Est.*, 115 T.C. 478, the Services' arguments under this provision were dismissed.

In *Strangi* the decedent, by his attorney-in-fact (also his son-in-law/attorney) created a family limited partnership and a corporate general partnership two months before the decedent's death. He transferred the decedent's property into the partnership in exchange for a 99% limited partner ownership interest. At death, decedent owned a 47% interest in the corporate general partnership, and his children owned the remaining 53%.

The Service argued, first, that the partnership had no business purpose or economic substance; second, that IRC section 2703 should apply; and third, that there had been a gift on formation of the partnership. While the transcript demonstrates that Tax Court was skeptical as to the propriety of the partnership's business purpose, it held that since it was valid under state law (Texas), the partnership had sufficient substance to be recognized for transfer tax purposes.

The court concluded that the Service's argument relating to Code Sec. 2703(a) – that the term "property" means the underlying partnership assets, and the partnership form is the "restriction" that must be disregarded – could not be supported by any language in the statute or regulations. The asset included in the decedent's estate was, instead, the decedent's interest in the limited partnership and corporation. Regarding the gift-on-formation argument, the court concluded that in light of the decedent's continuing interest in the partnership and the reflection of the contributions in his own capital account, the decedent did not transfer more than a minuscule proportion of the value that would be lost on the conveyance of his assets to the partnership in exchange for a limited partnership interest.

The Tax Court accepted the discounts offered by the Internal Revenue Service's expert, though noting that the discount may be "overgenerous" in favor of the taxpayer. An 8% minority interest discount and a 25% marketability discount were applied to the value of the limited partnership interest, for a combined discount of 31%.

Note that the Tax Court's decision was later affirmed by the Fifth Circuit Court of Appeals. (*Strangi v. Commr.*, 2005 U.S. App. LEXIS 14497, July 15, 2005)

It is also noteworthy that just days after the Tax Court decision in *Strangi*, the Internal Revenue Service released a private letter ruling (Field Service Advice Memorandum Letter Ruling 200049003) that contained facts very similar to those in *Strangi*. In this ruling the Service concluded that family limited liability entities, and transfers in those entities, should be disregarded because of the economic substance doctrine. In addition, the ruling noted that IRC section 2703 applied to these situations, so that any restriction on the right to sell an interest in the entities will be disregarded. Furthermore, the Service ruled that IRC section 2704(b) served to invalidate any discounts claimed as a result of the agreement's liquidation restrictions.



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IRC Section 2704

This section is titled, *Treatment of Certain Lapsing Rights and Restrictions*. Subsection (a) of this provision imposes a rule that states that certain lapsing restrictions of voting or liquidation rights in a partnership (or corporation) are treated as transfers subject to gift or estate tax, if the transferor and members of the transferor family control the entity, both before and after, the lapse of that right.

IRC section 2704(b) provides that if there is a transfer of an interest in a partnership (or corporation) to a member of the transferor's family, and immediately after the transfer, the transferor and members of his or her family control the entity, any "applicable restriction" is disregarded in determining the value of the transferred interest. An "applicable restriction" is one that effectively limits the ability of the partnership to liquidate, and with respect to which, the transferor or any member of his or her family, acting alone, or collectively, has the right to remove, in whole or in part, the restriction.

Treasury regulation 25.2704-2(b) provides that an applicable restriction is a limitation on the ability to liquidate the entity, that is more restrictive than would have been the case under state law, had the restriction not been in place. If an applicable restriction is disregarded, the transferred interest is valued as if the restriction did not exist, and as if the rights of the transferor were determined under the state law that would apply in the absence of the restriction.

IRS Rulings Under Section 2704

The Internal Revenue Service has addressed these provisions numerous times in Technical Advice Memorandums. In IRS TAM 9723009, the Service applied IRC section 2704(b) to the valuation of transferred interest in a family limited partnership. In this matter, the partnership agreement provided that the decedent could not withdraw from the partnership and liquidate her interest. Under the applicable state law, absent the restriction in the partnership agreement, the decedent could have withdrawn from the partnership and liquidated her interest with six-months notice. Because the partnership agreement provided a restriction greater than that available under state law, it was an "applicable restriction" and was disregarded for purpose of valuing the transferred interest.

IRS TAMs 9725002 and 9735003 provide further examples of the application of IRC section 2704(b) in disregarding certain restrictions meeting the definition of "applicable restrictions" under IRC section 2704(a). Note that these TAMs yield very similar results to those in IRS TAM 9723009, primarily because the facts are extremely similar.

In all, the Internal Revenue Service released seven TAMs in 1997 and 1998 which challenged the validity of family limited partnerships and refused to recognize them. As alternative arguments, the Service advised that even if the partnerships were recognized for transfer tax purposes, the restrictions on transferability and liquidation would be disregarded for valuation purposes under IRC sections 2703 and 2704(b).



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From all information presented in the TAMs, it appears that the Service was looking at fact patterns and situations which contained at least one of the following:

- The transaction included a transfer of liquid assets to a limited partnership
- The transferors were elderly and near the end of their lives
- The transfers were carried out by third parties that were generally related (children) under a power of attorney

The IRC Section 2036 Battleground

Perhaps the provision within the Internal Revenue Code most often used by the Service to challenge family limited partnerships is IRC section 2036. Titled, *Transfers with Retained Life Estate*, this provision of the Code requires that gifted property, including partnership interests over which the transferor/donor maintains the possession of or enjoyment of, or the right to the income from, the property (including partnership interests), or the right, either alone, or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom, shall be included in the estate of the transferor/donor.

Said another way, any gift over which the transferor/donor retains for life, or for a period of time which does not end before his or her death, possession and enjoyment (control) over the gifted property, or has the right to designate who gets that possession or enjoyment, will be disregarded under IRC section 2036(a), and that value will revert to his or her taxable estate.

IRS Challenges Under Section 2036

The Internal Revenue Service challenges under IRC section 2036(a) have wound through the courts, primarily the Tax Court, with reasonable level of success for the government. Such success demands that advisors recommending the use of family limited partnerships be familiar with the case law that has been decided in the last 15 years, and especially, the last five or six. Cases that require a careful reading and assessment in this area include the following:

- *Estate of Schauerhamer v. Comr.*, T.C. Memo, 1997-242
- *Estate of Harper v. Comr.*, T.C. Memo 2002-121
- *Estate of Thompson v. Comr.*, T.C. Memo 2002-246
- *Estate of Strangi v. Comr.*, 115 T.C. 478 (2002) (Strangi I) aff'd except reversed on 2036(a) issue
- *Strangi v. Comr.*, T.C. Memo 2003-145 (Strangi II) – 2036(a) opinion
- *Estate of Kimbell v. U.S.*, 244 F. Supp. 2d700(2003) on appeal to 5th Cir.
- *Estate of Ida Abraham v. Comr.*, T.C. Memo 2004-39
- *Estate of Lea Hillgren v. Comr.*, T.C. Memo 2004-46



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There are more cases predicated upon an IRC section 2036(a) challenge to the family limited partnership arrangement. However, the above list will provide a good idea of the framework under which the Internal Revenue Service raises these challenges. A sample of two of these cases are provided herein to illustrate the concept under which an IRC section 2036(a) argument might be raised in the course of an examination.

- *Schauerhamer* – In this case, the first of the IRC section 2036(a) cases, the decedent formed a separate limited partnership with each of her three children. She then transferred a substantial percentage of her ownership interest in the limited partnerships to family members, using the annual exclusion to avoid transfer taxes on the gifted interests. After the transfer of the partnership interest to other family members, the transferor/donor deposited income from the assets in the partnership into her personal account. In addition to partnership income deposits, she also deposited income from other sources into the same personal account. Over time, she used the funds that had been deposited into the personal account to pay both personal and partnership expenses.

The Internal Revenue Service again challenged the validity of the partnership and the partnership interest, suggesting that they should be disregarded based on the proper application of an IRC section 2703 analysis. Interestingly, the Tax Court turned away from the IRC section 2703 argument and, instead, applied IRC section 2036(a) to include all of the transferred interests in the estate of the decedent.

The Tax Court ruled that there was an “implied” agreement that the decedent would continue to retain the enjoyment of the income from the property, and as such, the transferred partnership interests were includible in the estate.

By virtue of this decision, it is easy to discern the importance of segregating funds and to ensure that all state laws and the partnership agreement are respected, and that the partnership is not just organized, but also operated, as a separate legal entity in all formalities.

- *Jorgensen Est. v. Comr.*, T.C. Memo 2009-66, aff’d, 2011-1 USTC ¶60,619 (9th Cir. 2011) – In this case the Tax Court found that IRC section 2036(a)(1) applied and ruled to include the value of assets previously transferred to two separate family limited partnerships in the decedent’s gross estate. The Court first determined that the assets transferred were not bona fide sales, as the decedent did not have a legitimate and nontax reason for the transfers.

While the decision sets out a number of factors that were considered, special weight was accorded the “non-arm’s-length” nature of the asset transfers and the partnership’s largely-untraded portfolio of marketable securities. It is noteworthy that neither party argued that the transactions were consummated for full and adequate consideration.

The most interesting aspect of the Court’s decision might be the finding of an implied agreement to retain IRC section 2036(a) interest or rights sufficient to have the transfers revert to the decedent’s estate.



Realities of Estate Planning with Family Limited Partnerships

The factors that led the Court to this decision include:

- The decedent had not retained sufficient assets after the transfers to satisfy her desire to make cash gifts to her family;
- The decedent and her estate used a substantial amount of the partnership's assets to pay the decedent's pre- and post-mortem expenses;
- The parties violated the pro-rata distribution requirements of the partnership; and
- The decedent's children, as co-trustees of the decedent's revocable trust had a fiduciary duty to administer the trust assets (including the partnership interests held by the trust) solely for the decedent's benefit and, as general partners of the partnerships, had discretion to administer the partnership assets.

Many of the cases, as noted earlier, carry a similar theme. Clearly, protection from the confines of IRC section 2036(a) simply requires complete and total separation from the transferred assets. Looking for degrees of control is a dangerous road on which to drive the estate planning of wealthy individuals.

Summary

While the challenges to using a family limited partnership can be daunting, proper analysis at the front end of the process, as well as putting together a well-crafted partnership agreement, can go a long way in mitigating these risks. Having the parties respect the partnership, both organizationally and operationally, should serve to minimize Internal Revenue Service scrutiny.

Understanding the salient Internal Revenue Code provisions, as well as state law and recent judicial decisions, will ultimately lead to a more successful design and implementation of a family limited partnership, ensuring that those individuals taking advantage of the benefits of this strategy will realize them as planned.



Realities of Estate Planning with Family Limited Partnerships

Chapter IV – Valuation of Family Limited Partnerships: Approaches

Valuations performed in connection with family limited partnerships can be very complex and should be prepared by qualified valuers/appraisers having an understanding of the nuances of valuing this type of entity, as well as certain positions taken by the Tax Court relating to the selection of valuation methodologies and discounts taken to arrive at the value of the partnership ownership interest under valuation. Family limited partnerships, more than other entities, are challenged by the Internal Revenue Service on many fronts, as discussed in the previous section. It is of the utmost importance that members of the legal community advise your clients regarding the risks and opportunities relative to the formation of family limited partnerships.

This chapter will provide an overview of the approaches to valuing family limited partnerships.

Types of Assets Placed in Family Limited Partnership

Assets contributed to a family limited partnership can include (but are not limited to) cash and cash equivalents, marketable securities, non-homestead real estate, oil and gas properties, buildings or equipment leased to an operating entity, and equity interests in privately-held businesses. In this geographic area, the authors of this material are participating in estate planning transactions that involve placing the oil and gas rights or a lease into a family limited partnership.

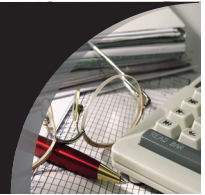
Standard of Value

Understanding assignment requirements regarding the appropriate standard of value is at the center of all business valuation. Failure to determine the proper standard of value will, inevitably, result in incorrect conclusions, based many times on the misapplication of premiums and discounts. The most common standard of value, fair market value, is applied in income, estate and gift tax, marital dissolution and, often, non-shareholder oppression litigation.

As noted earlier, fair market value is defined in the U.S. Treasury regulations (20.2031-1(b)) and Rev. Rul. 59-60, 59-1 CB 237 as:

“the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

In addition, Court decisions frequently state that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property. The definition requires that the valuation result be driven by a hypothetical sale transaction.



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Given that the definition requires consideration of a hypothetical sale, it stands to reason, then, that focus and attention must be given by a valuator to those hypothetical buyers and sellers, and to the concerns and issues that a potential hypothetical buyer and seller might consider prior to entering into a transaction. A key component of this definition is that a value determination based on special motivations of either a specific buyer or a specific seller would not be considered fair market value. Fair market value also anticipates that both the hypothetical buyer and seller have the ability, as well as the willingness, to enter into the hypothetical transaction.

The definition of fair market value anticipates a value determination under prevalent economic and market conditions at a particular date of valuation. To assume an economic or market turnaround at a point in time beyond the date of valuation will result in a value other than fair market value. Further, the definition also assumes that payment in the hypothetical transaction will be made in cash or its equivalent at the date of valuation. Thus, consideration of any deferred financing or special purchase arrangement is not appropriate when the goal is to identify fair market value.

Finally, fair market value, by definition, must allow a reasonable time for exposure in the open market. For equity ownership interests requiring longer periods of exposure, marketability, or rather, the lack of marketability, presents a greater investment risk and, therefore, a value detriment. Often this value detriment is addressed in the business valuation process as a discount.

Revenue Ruling 59-60 notes that a determination of fair market value, being a question of fact, will depend on the circumstances specific to each case. The ruling requires the appraiser to “maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.”

While the ruling emphasizes the review and analysis of all relevant criteria, it does present the following listing of specific, though not all inclusive, fundamental factors to be considered in the valuation process.

- The nature of the business and the history of the enterprise from its inception
- The economic outlook in general and the condition and outlook of the specific industry in particular
- The book value of the stock and the financial condition of the business
- The earning capacity of the Partnership
- The dividend-paying capacity
- Whether or not the enterprise has goodwill or other intangible value
- Sales of the stock and the size of the block of stock to be valued
- 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



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There are other standards of value including investment value, intrinsic value and fair value, which are beyond the scope of this material. In most instances, family limited partnerships are used as a planning mechanism for preserving and transferring wealth from one generation to another, and therefore, the applicable standard of value is fair market value.

Premise of Value

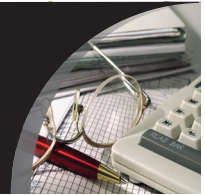
In addition to defining the standard of value for an assignment, it is important to determine the applicable premise of value. The premise of value is an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation. Premises of value include either going concern or liquidation. Most often valuation professionals work under the going concern premise of value, meaning that the existing management (the general partner(s)) of the subject family limited partnership will remain into the future and will maintain the character and integrity of the company. A liquidation premise would provide the net amount that would be realized if the business terminated and the assets were sold piecemeal. Liquidation can be either “orderly” or “forced.” Although in many instances the valuator will apply a cost/asset approach in valuing an interest in a family limited partnership, as they are basically holding companies, the premise of value would be going concern.

Date of Valuation

The date or dates on which the subject family limited partnership will be valued is critically important because events and circumstances can arise that can cause value to vary materially from one date to another. The date of valuation influences the information available for the valuation. It is the perspective from which all analysis is performed in the valuation.

From a planning perspective, assets are transferred to a family limited partnership prior to significant, anticipated appreciation. Strategies are employed to move assets, including real estate and marketable securities, during times supporting depressed values. For example, with the declining stock market in 2011 many family limited partnerships were funded with marketable securities.

Since a valuation is prepared “as of” the valuation date, subsequent events and data are typically not considered. Professional standards require that all information considered by the valuator must be known or knowable to a potential purchaser of the subject interest as of the date of valuation. The Tax Court generally supports this thinking relative to subsequent events. However as noted by the Court, an event occurring after a valuation date, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation, to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property at the valuation date (*Estate of Noble v. Commissioner*, T.C. Memo 2005-2).



Realities of Estate Planning with Family Limited Partnerships

Approaches to Valuation

There are many factors that impact the selection of an approach or approaches used to value a family limited partnership. Selection generally revolves around the quality of available information relevant to the respective approaches and the prospects for liquidation or continued operation. The relative qualifying evidence available to support use of a particular approach is the critical determinant driving the selection of an approach.

Revenue Ruling 59-60, the Internal Revenue Service's primary authoritative pronouncement over the last 50 years on the valuation of privately-held business interests, addresses use of the Cost/Asset Approach as follows:

"Earnings may be the most important criterion of value in some cases, whereas, asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued."

Revenue Ruling 59-60 goes on to say that:

"The value of the stock of a closely-held investment or real estate holding company, whether or not family-owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be afforded greater weight in valuing the stock of a closely-held investment or real estate holding company, whether or not family-owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend-paying capacity."

As Revenue Ruling 59-60 suggests, the Tax Court relies more on an asset-based approach in valuing holding companies and on earnings-related methods for operating companies. For hybrid companies, the Tax Court often accords partial weight to both methods.

Asset-Based Approach

Generally, the *Underlying Assets Methods* are more suited to valuing controlling interests. And these methods should only be used to value minority interests if those interests can cause the company to sell its assets, or if the company is the type of company whose stock should normally be valued primarily on an asset basis (i.e., an investment holding company or family limited partnership). As a result, these methods generally produce a control, marketable value.



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The Asset Approach to valuing privately-held business ownership interests is primarily a function of modifying balance sheet assets and liabilities from historical “carrying” values to economic values at the date of valuation (generally, fair market value). A fundamental accounting principle is the book value of assets less the book value of liabilities equals the book value of owners’ equity, while a fundamental valuation principle is the current value of assets less the current value of liabilities equals the current value of the business owners’ equity. Once adjusted, the enterprise value or total value of the subject company is determined simply by netting assets and current liabilities, including all non-interest-bearing debt obligations.

The valuator must have an understanding of the accounting principles that were used to prepare the subject family limited partnership’s financial statements. For example, in the case of marketable securities, the valuator must ascertain whether the securities are recorded at the original cost or market value. All assets and liabilities should be restated to current values using the appropriate standard of value. This standard of value should be consistent with that used for the overall family limited partnership valuation.

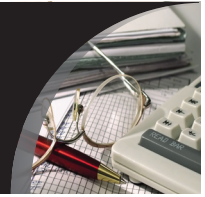
All of the family limited partnerships assets and liabilities should be considered for re-evaluation. Therefore, depending on the type of asset, the valuator may be relying on different sources for indicators of fair market value. In some cases the valuator may need to rely on other experts in determining the fair market value of certain assets of the family limited partnership, notably, tangible assets. Tangible assets include land, buildings, site improvements, computers, furniture, machinery, vehicles and other equipment. Business valuation experts are not expected to be expert appraisers of tangible assets. The business valuator, however, should know the basics of how these appraisals are conducted. All appraisal disciplines recognize the three basic valuation approaches including income, market (“sales comparison”) and cost. In the case of marketable securities the valuator will refer to investment statements for the market value at the valuation date.

Real Estate Appraisals

In the appraisal of real estate it is important to distinguish between *real estate* and *real property*. Legally defined, real estate includes land and all things that are a natural part of it (i.e., minerals) and all things that are attached to it by people (i.e., building and pavement). Real property includes the bundle of rights that is inherent in the ownership of real estate. The following highlights the key aspects involved in the appraisal of real property.

Types of Interests

The bundle of rights theory maintains that ownership of a parcel of real estate may embrace a great many rights, such as the right to its occupancy and use; the right to sell it in whole or in part; the right to bequeath; the right to



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transfer by contract for specified periods of time, the benefits to be derived by occupancy and use of the real estate. It is possible to own all of the rights in a parcel of real estate or only a portion of them. For most common situations, the fee simple interest is explicitly assumed since it is the most complete bundle of rights available. While there are many different possible interests in real estate, the three most common are:

- Fee simple estate – This is the most complete ownership in real estate, subject to the limitations imposed by governmental powers of taxation, escheat, eminent domain and police power.
- Leased fee estate – This is simply the fee simple interest encumbered by a lease. If the lease is at market rent, then the leased fee value and the fee simple value are equal. However, if the tenant pays more or less than market, the residual owned by the leased fee holder, plus the market value of the tenancy, may be more or less than the fee simple value.
- Leasehold estate – The interest held by a tenant through a lease conveying the rights of use and occupancy. If the tenant pays market rent, then the leasehold has no market value. However, if the tenant pays less than market, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value. For example, a major chain retailer may be able to negotiate a below-market lease to serve as the anchor tenant for a shopping center. This leasehold value may be transferable to another anchor tenant, and if so the retail tenant has a positive interest in the real estate.

Standard of Value

- Market value – This is the most commonly used standard of value. While the Uniform Standards of Professional Appraisal Practice (USPAP) does not define market value, it provides general guidance for how it should be defined:

“a type of value, stated as an opinion, that presumes the transfer or sale of a property as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal.”

The market value standard recognizes value to a theoretical market, based upon exposure time required for similar properties.

- Value-in-use – This is the net present value (NPV) of a cash flow that an asset generates for a specific owner under a specific use. Value-in-use is the value to one particular user, and is usually below the market value of a property. For example a special-purpose manufacturing facility may have a higher market value-in-use to its current owner that is much higher than its value-in-exchange to an alternate owner.



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- Investment value – This is the value to one particular investor, and not necessarily the value in the marketplace.
- Going concern value – This is “the value of a proven property operation. It includes the incremental value associated with the business concern, which is distinct from the value of the real property. The value of the going concern includes an intangible enhancement of the value of the operating business enterprise, which is produced by the assemblage of land, buildings, labor, equipment and the marketing operation. The assemblage creates an economically viable business that is expected to continue. The value of the going concern refers to the total value of a property including both the real property and the intangible property attributed to the business value.”¹
- Insurable value – This is the value of real property covered by an insurance policy. Generally it does not include the site value.
- Liquidation value – This may be analyzed as either a forced liquidation or an orderly liquidation and is a commonly sought standard of value in bankruptcy proceedings. It assumes a seller who is compelled to sell after an exposure period that is less than the normal-market timeframe.

Highest and Best Use

“Highest and Best Use” is a term of art in the appraisal process. It is a process to determine the use of the property that produces the highest value for the land, as if vacant. There are four steps to the process. First, the appraiser determines all uses which are legally permissible for the property. Second, of the uses which are legally permissible, the appraiser determines which ones are physically possible. Of those, the appraiser determines which ones are financially feasible. Finally, of those uses which are feasible, the appraiser determines which one and only use produces maximum profits for the site.

In a simple context, the appraiser must do this twice, comparing the results – as if the land is vacant and in the as-is-improved state, taking into account the costs of demolishing any existing improvements. The outcome of this process is the highest and best use for the site. An appraisal of market value must explicitly assume that the owner or buyer would employ the property in its highest and best use and, therefore, value the site accordingly.

In more complex appraisal assignments (i.e., contract disputes, litigation or contaminated property valuation), the determination of highest and best use may be much more complex, and may need to take into account the various intermediate or temporary uses of the site, the contamination remediation process and the timing of various legal issues.

¹ *The Appraisal of Real Estate*, 11th Edition



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Approaches to Value

As previously noted, all appraisal disciplines recognize the three basic valuation approaches including income, market (“sales comparison”) and cost. All three approaches are commonly applied in the context of real estate appraisals.

- *Cost Approach* – The cost approach was formerly called the summation approach. The theory behind this approach is that the value of a property can be estimated by summing the land value and the depreciated value of any improvements. The value of the land is the value of its highest and best use. The value of the improvements is referred to as the *reproduction cost new less depreciation* or *replacement cost new less depreciation*.

Reproduction cost refers to the cost of reproducing an exact replica. Replacement cost refers to the cost of building a house or other improvement that has the same utility, but using modern design, workmanship and materials. Typically in practice, appraisers use replacement cost and then deduct a factor for any functional dis-utility associated with the age of the subject property. In most instances when the cost approach is involved, the overall methodology is a hybrid of the cost and sales comparison approaches. For example, while the replacement cost to construct a building can be determined by adding the labor, material and other costs, land values and depreciation must be derived from an analysis of comparable data.

The cost approach is considered reliable when used on newer structures, however, the method tends to become less reliable for older properties. The cost approach is often the only reliable approach when dealing with special-use properties.

- *Market (Sales Comparison) Approach* – The market (hereinafter referred to as sales comparison) approach in a real estate appraisal is based primarily on the principle of substitution, which assumes a prudent buyer will pay no more for a property than it would cost to purchase a comparable substitute property. The approach recognizes that a typical buyer will compare asking prices and seek to purchase the property that meets his or her wants and needs for the lowest cost.

The sales comparison process involves the judgment of the real estate appraiser, as to the similarity of the subject property and the comparable sales or listings, relative to numerous factors including location, size, quality of construction, age and condition. Further, the real estate appraiser attempts to interpret and measure the actions of parties involved in the marketplace, including buyers, sellers and investors. Since comparable sales are not always identical to the subject property, adjustments are frequently made for date of sale, location, style, square footage, site size, etc. The primary objective is to simulate the price that would have been paid if each comparable sale were identical to the subject property.



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- Income (Income Capitalization) Approach – The income capitalization approach (hereinafter referred to as the income approach) is used to value commercial and investment properties. Because it is intended to directly reflect or model the expectations and behaviors of typical market participants, this approach is generally considered the most applicable valuation technique for income-producing properties, where sufficient market data exists to supply the necessary inputs and parameters for this approach.

The approach includes capitalizing or discounting an income stream to produce a value of the subject property. The income stream is Net Operating Income (NOI), which is defined as gross potential income (GPI), less vacancy and collection loss less operating expenses (but excluding debt service, income taxes, and/or depreciation charges). The real estate appraiser will consider all of the aforementioned factors in preparing his or her appraisals. Additionally, credentialed appraisers will adhere to certain standards relative to due care, development and reporting. It is important to note that the conclusions provided in real estate appraisals will include a period of time that the property is exposed to the market.

Machinery and Equipment Appraisals

Machinery and equipment (hereafter sometimes referred to as “M&E”) appraisals are not as location-specific as real estate. In many cases an appraiser of M&E has a niche expertise, for example a specific industry or asset. M&E appraisals may be performed for a number of purposes, including purchase price allocation, financing, insurance, litigation, leasing or property tax. The following highlights the key aspects involved in the appraisal of machinery and equipment.

Standard of Value

- Fair Market Value is defined by the American Society of Appraiser’s Machinery and Technical Specialties Committee as an estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, as of a specific date.
- Fair Market Value – Removal is an estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, as of a specific date, considering the cost of removal of the property to another location.
- Fair Market Value in Continued Use is an estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation, as of a specific date and assuming



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that the business earnings support the value reported. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs, to make the property fully operational.

- Fair Market Value – Installed is the estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation, as of a specific date. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs to make the property fully operational.

Premise of Value

- Orderly Liquidation Value is the estimated gross amount, expressed in terms of money, that could be typically realized from a liquidation sale, given a reasonable period of time to find a purchaser, with the seller being compelled to sell on an as-is, where-is basis, as of a specific date.
- Forced Liquidation Value is the estimated gross amount, expressed in terms of money, that could be typically realized from a properly advertised and conducted public auction, with the seller being compelled to sell with a sense of immediacy on an as-is, where-is basis, as of a specific date.

Approaches to Value

All three approaches to value are considered when valuing M&E, however, the income approach is not commonly used to determine the value of an individual piece of machinery and equipment. This is due to the inability to isolate the given piece of M&E to determine its income stream. However, the cost and market approaches are widely used for valuing M&E.

- Cost Approach – This approach is the best determinant of value for a special-purpose asset or one without an active secondary market. Using this approach an appraiser will compute one of two costs: *reproduction cost new* or *replacement cost new*. The reproduction cost new is the cost to create an exact duplicate of the subject, while the replacement cost new is the cost to create one with equal capacity and utility as the subject, but using current technology. An appraiser is likely to use one of three methods to determine the *current cost new*. These methods include direct unit pricing, trending and cost/capacity.

The direct unit pricing method involves the appraiser inventorying the assets at the facility and recording and identifying information relative to the assets (manufacturer, model/serial number, year manufactured, etc.) Additionally the appraiser will consider the machine's installation in the facility. Each asset is individually identified and valued.



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The trending method is when the appraiser uses existing accounting records as the basis for the inventory of assets to be valued. The appraiser then uses a unit of production method, where costs will be known to manufacture an entire facility or a major component of a process plant. This method results in a check on the sum of the trended individual costs for that facility as a whole. Therefore, it is not necessary to comment on each individual line item.

Finally, in the cost/capacity method, the costs of similar equipment or process plants can vary based on size or capacity raised to a power. The formula used is: $C2/C1 = (Q2/Q1)^x$

In the formula, C2 is the desired cost of capacity (Q2) and C1 is the known cost of capacity (Q1). These costs are scaled using factors typically called the six-tenths factor, where costs can be scaled up or down within reasonable ranges. The formula is used as a check on the reasonableness of the sum or the trended costs for a facility, in part or in whole.

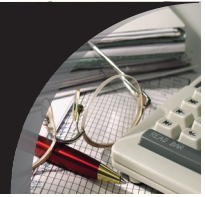
There are three categories of adjustments to value that account for physical depreciation and functional and economic obsolescence. The adjustments are beyond the scope of these materials.

- Market (Sales Comparison Approach) – This approach includes an analysis of recent sales and current offerings of similar pieces of machinery. It is often used in determining value for financial purposes and can be the most supportable approach in terms of market indicators. The strength of the market approach is its ability to contemplate all forms of depreciation.

The identification of comparable sales and offerings of similar property is similar to that described for real estate appraisals. Once adjustments are made to comparable sales and asking prices, the addition of allowances for direct and indirect costs necessary to assemble the property as an integrated, functional unit will result in fair market value in continued use.

- Income Approach – This approach is used primarily for the valuation of integrated production facilities, special-purposes assets, and to quantify obsolescence penalties. Usually a personal property appraisal includes the finite life of personal property. The methods under the income approach include direct capitalization and discounted future cash flow. Asset value will be affected by the ability of the entity to have sufficient earnings to support concluded values for various components of a going concern. If there are no earnings, the assets may be appraised at orderly or forced liquidation value.

As in the appraisal of real estate, the machinery and equipment appraiser will consider all of the aforementioned factors in preparing his or her appraisals. Additionally, credentialed appraisers will adhere to certain standards relative to due care, development and reporting.



Realities of Estate Planning with Family Limited Partnerships

Income Approach

In the event the family limited partnership structure includes an investment in an operating business, the income approach will be used to determine value. The income approach is based upon the principle of anticipation. In theory, the value of a business depends on the future benefits that will accrue to it, with the value of future economic benefits discounted back to present value at an appropriate discount rate.

Determination of value under the income approach can be accomplished through the proper application of three primary methodologies:

- Capitalized cash flow method (CCF)
- Discounted cash flow method (DCF)
- Excess cash flow method (ECF)

Each method requires the determination of a “future benefit stream,” a numerator, and a rate of return (risk), a denominator. The CCF method utilizes just one numerator and denominator, whereas the DCF utilizes a series of fractions. The ECF method is really a hybrid method, combining elements of both the asset and the income approaches.

Conclusion

Once all of the assets and liabilities of the family limited partnership are adjusted to fair market value, certain valuation adjustments including those for lack of control and/or lack of marketability will be made to arrive at the value of the family limited partnership interest under valuation.

An example of the application of the approaches will be presented in Chapter VI.



Realities of Estate Planning with Family Limited Partnerships

Chapter V – Valuation of Family Limited Partnerships: Discounts

Multi-Level (Tiered-Entity) Discounts

We often experience high-net-worth clients owning equity interests in multi-tier entities. A tiered entity structure is generally defined as holding companies that own an interest in another company or companies. Questions then arise, for valuation purposes – can discounts be applied to each entity within the structure and, if so, what is the amount of the discount at each level?

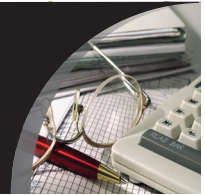
A typical structure includes a “top tier” company (family limited partnership) holding investments (or interests) in other “lower tier” entities. The interest under valuation will be a minority (or non-controlling) interest in the “top tier” company or family limited partnership.

Typically discounts for lack of control and marketability, if it is determined that they are applicable, are first applied to the lower tier entity level and then to the top tier level. There needs to be an assessment of the issues or factors impacting the discounts at the lower tier. Then the valuator will consider the incremental differences existing at the top tier level. Discount levels will differ in the instance where there are different general partners at each level, as opposed to a tiered structure where the general partners are the same at each level.

The Internal Revenue Services has established a history of challenging multi-level discounts on the grounds of being duplicative. The U.S. Tax Court and other federal courts have opined on the appropriateness of applying multi-level discounts. The following is a listing of cases in which the court allowed multi-level valuation discounts:

- *Estate of Astleford v. Comr.*, T.C. Memo 2008-128 (summarized in Chapter VII)
- *Estate of Dean v. Comr.*, T.C. Memo 1960-54
- *Estate of Gallun v. Comr.*, T.C. Memo 1974-284
- *Estate of Gow v. Comr.*, T.C. Memo 2000-93, aff'd 19 Fed. Appx. 90 (4th Cir. 2001)
- *Estate of Hjersted*, 175 P.3d 810 (Kan. 2008)
- *Estate of Kosman v. Comr.*, T.C. Memo 1985-424
- *Piper v. Comr.*, T.C. 1062 (1979)
- *Whittemore v. Fitzpatrick*, 127 F.Supp 710 (D. Conn. 1954)

The application of discounts in a multi-tiered structure is difficult, and discounts at each level should be based on a critical analysis of the facts and circumstances of each case. When properly developed and analyzed, tiered-entity discounts can sustain an IRS challenge.



Realities of Estate Planning with Family Limited Partnerships

Why Discounts are Applicable to Interests in Family Limited Partnerships

When preparing a valuation report for a family limited partnership for estate planning purposes, valuers tend to refer to Revenue Ruling 59-60, 1959-1 CB 237, both to define the term “fair market value,” and in providing guidance about specific factors to be considered in valuing closely-held business interests.

As previously discussed, Revenue Ruling 59-60 (along with the Treasury Regulations) specifies that the valuation test is the hypothetical “willing buyer-willing seller” test. That is, the value of property “is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.”

Under the willing buyer-willing seller test, each interest has a value that may be considerably less than each owner’s pro-rata share of the partnership’s underlying assets. There are three general reasons (as follows) why a hypothetical buyer would not purchase the limited partner ownership interest based solely on the value of the underlying assets:

1. Lack of management participation – As an owner of a limited partnership interest, the buyer would have no control over the investment of the family limited partnership’s assets, including disposition of current assets, investments in alternative assets, or risk tolerance assumed as a result of any new alternative investments. Control lies with the partnership’s general partner(s).
2. Minority interest (lack of control) – A fractional limited partner interest represents a non-controlling interest in a typical family limited partnership structure. It is difficult to find a buyer interested in acquiring a non-controlling interest in a family limited partnership, especially if he/she may have to wait an indefinite time to cash out.
3. Marketability discount – There is no formalized open market where a limited partner ownership interest in family limited partnership can trade in a manner that would allow an investor to liquidate his/her interest in a timely manner as defined in Revenue Ruling 59-60. If the buyer needs cash, he/she would probably not be able to sell such an interest except at a substantial discount.

Discounts for Lack of Control

Control premiums and discounts for lack of control – sometimes referred to collectively as “control adjustments” – have enjoyed wide acceptance in the federal tax system. The estate and gift tax regulations on valuing publicly traded stock recognize a basic inequality between controlling and non-controlling interests, noting in Treasury regulation sections 20.2031-2(e) and 25.2512-2(e):

If the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.



Realities of Estate Planning with Family Limited Partnerships

Regulation sections 20.2031-2(f) and 25.2512-2(f) also list as a factor in valuing closely-held stock “the degree of control of the business represented by the block of stock to be valued.” This provision prompts swing vote consideration as well.

Revenue Ruling 59-60, clarifies which way this factor cuts. The ruling states:

Although it is true that a minority interest in an unlisted corporation’s stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

The determination of whether a discount for lack of control is applicable depends on the interest being valued and on the valuation approach utilized. Typically, the primary approach used in connection with valuing this type of entity is a net asset value approach, which represents the value of the family limited partnership on a controlling basis, since only a controlling interest holder could decide to replace or liquidate assets or put them to their highest and best use in a going-concern context. General valuation theory suggests that if the full value of all intangible assets is fully reflected in the asset-based valuation approach, then non-controlling shares typically sell at a substantial discount from such value.

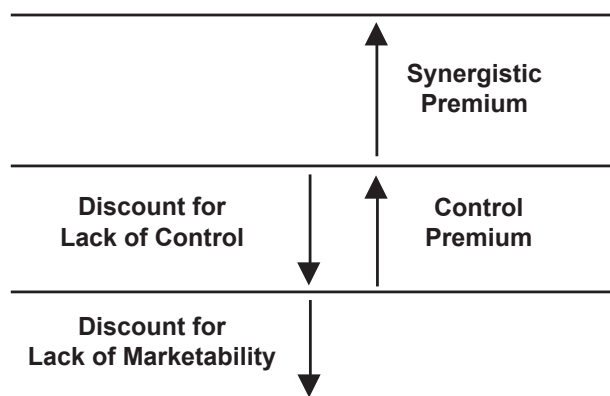
The chart below illustrates levels of value in terms of ownership characteristics.

Control, Marketable Value
(on an investment or a synergistic value basis)

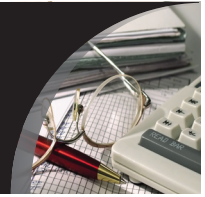
Control, Marketable Value
(on an FMV basis)

Minority, Marketable Value

Minority, Non-marketable Value



Note the highest level of value is on an investment or synergistic value basis and not fair market value. A controlling interest in a privately held business may also be subject to a discount for lack of marketability, but usually not at the same level as a minority or non-controlling interest.



Realities of Estate Planning with Family Limited Partnerships

The determination of an appropriate discount for lack of control is based on the facts and circumstances of each particular valuation engagement. The family limited partnership agreement will be carefully analyzed and factors that are deemed critical in the discount analysis will be considered. The factors listed below demonstrate some of the items a willing buyer would consider when assessing whether or not to acquire an interest in a family limited partnership.

- Management and Voting Rights – The general partner(s) typically have sole management powers and duties as detailed in the family limited partnership agreement. The limited partners have no control over the management of the family limited partnership.
- Restrictions on Dispositions – The family limited partnership agreement will describe the type of transfers that can be made in accordance with the agreement. Some agreements provide that general partners may not transfer their interests, with few exceptions. Limited partners may be permitted to transfer interests to certain lineal descendants and/or any transfer would be subject to the right of first refusal.
- Minimum Distribution Requirements – The family limited partnership agreement will typically specify how cash flow may be distributed to the partners, which is usually determined by the general partner(s). In many cases, the intent of the family limited partnership is to reinvest the cash flows as they are recognized. Therefore, cash flows to be distributed are expected to be nominal or zero, and the final decision on actual cash distributions (i.e., determination of cash flow) is at the sole discretion of the general partner(s).
- Partnership Control – Limited partners have no part in the control of the business of the family limited partnership and have no authority to act on behalf of the family limited partnership.

Sources of Lack of Control Discounts

The market evidence available to assist in quantifying discounts for lack of control (minority interest discounts) generally compares control acquisition prices with pre-acquisition minority interest transaction prices. Implied minority discounts are derived from the inverse of the control premiums.

Mergerstat® Review is published annually by FactSet Mergerstat, LLC. The publication provides an extensive analysis of tender offers and completed transactions by industry. The premium paid over market is based on the seller's closing market price five business days prior to the initial announcement of sale. This may understate the control premiums and, therefore, the implied minority interest discounts, because the stock of the target's acquisition may begin to rise more than five days prior to the public announcement. Negative premiums are excluded.

The implied minority discount is calculated as follows:

$$1 - [1 / (1 + \text{Median Premium Paid})]$$



Realities of Estate Planning with Family Limited Partnerships

A historical analysis of the control premiums and the corresponding minority discounts calculated in Mergerstat® Review are as follows:

<i>Year of Buyout</i>	<i>Number of Transactions</i>	<i>Average Premium Paid over Market (%)</i>	<i>Median Premium Paid over Market (%)</i>	<i>Implied Minority Interest Discount (%)</i>
1999	723	43.3	34.6	25.7
2000	574	49.2	41.1	29.1
2001	439	57.2	40.5	28.8
2002	326	59.7	34.4	25.6
2003	371	62.3	31.6	24.0
2004	322	30.7	23.4	19.0
2005	392	34.5	24.1	19.4
2006	454	31.5	23.1	18.8
2007	491	31.5	24.7	19.8
2008	294	56.5	36.5	26.7
2009	239	58.7	39.8	28.5
2010	348	51.5	34.6	25.7

Source: Mergerstat® Review 2011 (Santa Monica: FactSet Mergerstat, LLC)

The annual median control premiums over this historical period range from 23.1% to 41.1%, while the mean ranges from 30.7% to 62.3%. It was previously noted that negative premiums are excluded. If negative premiums were considered, the average premium in 2010 would be 46.5%, and the median premium would be 32.5%, based on 376 transactions. Further, the dispersion of premiums is broad, with 93 of the 349 transactions having a premium under 20%, to 36 transactions having a premium of over 100%.

There are some issues with the Mergerstat® Review data including:

- Data for the computations is extrapolated from the reported financial information and not the adjusted financial information both parties might consider.
- The observation methodology does not provide for quantification of buyer differences – specific transactions result from specific buyers with alternative motives. As such, transactions with synergistic buyers are interspersed with transactions with financial buyers.

Valuators may attempt to remove the impact of the synergistic premium by judgmentally removing a portion of the control premium and then proceed to calculate the implied discount.



Realities of Estate Planning with Family Limited Partnerships

In the instance that the subject family limited partnership is holding marketable securities, which is a common asset holding, the discount for lack of control can be quantified using data derived from closed-end funds. Closed-end funds are the aggregated monetary assets of investors seeking collective buying power, which affords an opportunity to participate in a well-diversified, professionally-managed investment portfolio. Closed-end funds maintain a relatively stable investment base through the use of a fixed number of shares that are traded on the public market. The price of the shares of a closed-end fund is subject to the economic laws of supply and demand.

Databases like Morningstar Principia Closed-End Funds allow the valuator to search the closed-end funds by category including domestic equity, international equity, discounted, premium, taxable bond, municipal bond and indexes. Additionally, the closed-end fund investments can be searched by industry (i.e., healthcare, energy, financial). This will allow the valuator to search for closed-end funds with similar investment characteristics to the subject family limited partnership's marketable securities, which enhances comparability. As noted previously, it is critical to drill down into the empirical studies and databases to draw comparability to the subject family limited partnership's assets.

Discounts for Lack of Marketability

Protection from many risks attendant to holding a minority interest in a business can be controlled in the public stock market by selling the equity holdings, should the holder decide that management actions are elevating his or her risk beyond an acceptable level. This same ability to liquidate (convert into cash) an interest in a privately-held company rarely exists. Moreover, due to size and other specific company nuances, as well as a lack of a perfect market mechanism for disposition, risk attendant to a lack of liquidity or of marketability can often be an issue for even a control interest in a privately-held enterprise.

The ability to convert an investment from an illiquid asset to cash is an ownership characteristic of considerable value. Often, when this trait is missing, an investor is subject to substantially-higher risk, and valuation of the attendant equity interest must be adjusted accordingly.

Marketability was defined in a recent IRS Job Aid on the topic of discounts for lack of marketability. The definition is as follows:

"the ability to quickly convert property to cash at minimal cost"² ...

"with a high degree of certainty of realizing the anticipated amount of proceeds."³

² International Glossary of Business Valuation Terms, 2001, American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, The Institute of Business Appraisers.

³ Shannon P. Pratt, Alina v. Niculita, Valuing a Business, The Analysis and Appraisal of Closely Held Businesses, 5th Ed.



Realities of Estate Planning with Family Limited Partnerships

The Job Aid addresses the distinction between marketability and liquidity, with liquidity being defined as, “the ability to quickly convert property to cash or pay a liability.” Further, the Job Aid notes that marketability is an indication of “the fact of “salability,” while liquidity is an indication of “how fast that sale can occur at the current price.”

This definition is emphasized by a series of three clarifying examples within the Job Aid.

- If it’s (an asset) liquid, it’s marketable
- If it’s nonmarketable, it’s illiquid
- Being illiquid does not necessarily equate to nonmarketable – [the asset] may still be sellable, but not quickly or without a loss of value.

Quantification of the discount for lack of marketability is an arduous task, even for the most seasoned of valuation professionals. A great amount of research has been developed over the last four decades in an attempt to quantify the phenomenon of illiquidity as it applies to a specific investment. However, valuers continue to struggle with the reconciliation of the available research to the attendant equity interest under valuation. A logical path from the research to the ultimate discount selected is imperative to attain the proper conclusion of value.

Sources of Lack of Marketability Discounts

There are four broad categories of discounts for lack of marketability including benchmark studies, securities-based approaches, analytical approaches and other approaches. As business valuation has evolved, valuers are no longer applying average or median discounts from empirical studies, but rather drilling down into the empirical studies and/or employing other quantitative models.

Benchmark Studies

There are two categories of empirical data which assist the appraiser in quantifying the discount required for lack of marketability relative to a minority interest: (1) discounts on sales of restricted shares of publicly-traded companies; and (2) discounts on sales of privately-held company shares compared to prices of subsequent initial public offerings of the same companies’ shares.

Restricted Stock Studies

This method takes into account the inherent discount that exists in transactions of letter stocks. A letter stock is identical to the freely-traded stock of a publicly-traded company, except that it is restricted from trading on the open market for a certain period, usually no longer than 24 months. Since the only difference between the letter stock and its freely traded counterpart is the existence of an immediate market, the price spread between the two stocks is often held to be the discount required for the lack of marketability.



Realities of Estate Planning with Family Limited Partnerships

A number of studies have been conducted to determine the average discounts reflected. A summary of the results of selected studies cited below is provided as follows:

Study	Transactions		Mean	Std. Dev.	Range	
	Observed	Median			Low	High
SEC Inst. Investors	398	24%	26%	N/A	(15%)	80%
Gelman	89	33%	33%	N/A	<15%>	40%
Moroney	146	34%	35%	18%	(30%)	90%
Maher	34	33%	35%	18%	3%	76%
Trout	60	N/A	34%	N/A	N/A	N/A
Williamette Mgt.	33	31%	N/A	N/A	N/A	N/A
Stryker/Pittock	28	45%	N/A	N/A	7%	91%
Silber	69	N/A	34%	24%	(13%)	84%
Hall & Polacek	100+	N/A	23%	N/A	N/A	N/A
Johnson	72	N/A	20%	15%	(10%)	60%
CFIA (1)	23	14%	21%	N/A	0.8%	68%
CFIA (2)	15	9%	13%	N/A	0%	30%
Mgt. Planning (1)	53	25%	27%	N/A	3%	58%
Mgt. Planning (2)	27	9%	12%	N/A	N/A	N/A
FMV Opinions	243	20%	22%	16%	N/A	N/A
Averages		<u>25%</u>	<u>26%</u>			

The *SEC Institutional Investor Study of 1971* compared the difference in value of restricted stock, also known as letter stock. The marketable securities of companies held by institutional portfolios are generally larger, in terms of market capitalization, than the companies issuing restricted securities. The study's results equated to a mean discount of nearly 26%. Over 93% of the transactions with discounts between 40% and 50% involved over-the-counter stocks. The class of stock studied that most closely resembled that of a privately-held company is the non-reporting over-the-counter companies, which had an average discount of nearly 33%.



Realities of Estate Planning with Family Limited Partnerships

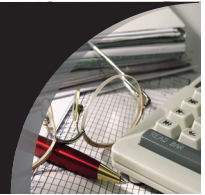
A financial model was constructed to estimate the discount that should be accorded investment letter stock in the *Trout Study* (1977). During the five-year period, 1968 through 1972, 60 purchases of investment letter stock by six mutual funds were analyzed. Trout applied a multiple regression analysis to the data after defining five variables that can influence the size of the discount. The variables were the exchange listing, number of shares outstanding, number of shares purchased as a percent of the shares outstanding, purchases of less than 1%, and value of the purchase. The analysis resulted in a discount of 33.5%. Trout concluded that the statistical correlations indicate “a moderate ability of this model to account for variations in the observed discounts.”

The *Standard Research Consultants Study by Stryker and Pittock* was published in 1983. This study analyzed private placements of common stock to test the current applicability of the 1971 SEC study that was described earlier. Twenty-eight private placements of restricted common stock were analyzed from December 1978 to June 1982. The discounts ranged from 7% to 91% with the median at 45%.

The 1991 *Silber Study* analyzed purchases of restricted securities by institutional investors as reported by Securities Data Corporation for the period of 1981 through 1988. The initial 310 private placements of publicly-traded common stock were narrowed down to 69, which eliminated transactions with special situations, such as warrants attached. The median of 35% was calculated by applying the least-squares estimation. More importantly, the study noted certain correlations. It noted that firms with higher revenues, earnings and market capitalization were associated with lower discounts, and vice versa. It also noted that discounts are larger when a block of restricted stock is large relative to total shares outstanding, and likewise volume (in dollars) is inversely related to size of discount.

The *Hall & Polacek Study* took a slightly different approach to justifying higher discounts as it analyzed the change in Tax Court decisions, between 1981 and 1993, regarding minority interest and lack of marketability discounts. Inclusive of this study, it also analyzed the results of the FMV Opinions, Inc. restricted stock study. The FMV Opinions Study examined over 100 restricted stock transactions from 1979 through April 1982. This study is often regarded as an update of the Institutional Investor Study Report of the SEC, and its results were very similar. The Hall & Polacek study agreed that the size of the subject company’s revenues, earnings, and the exchange on which it was traded correlated to the size of the discount, but it also noted that the dollar value of the block of stock, the percentage size of the block of stock being sold, and the market value or capitalization of the issuing company would have a bearing on the size of the discount. The study’s mean discount calculated to be 23%, which is very similar to the SEC study.

One of the more recent studies, the *Johnson Study* of 1999, studied 72 transactions that occurred between 1991 and 1995, and noted an average discount for lack of marketability of 20%. The study explained the decrease in marketability discount was caused by the increase in prospective buyers for restricted stocks. This study also analyzed



Realities of Estate Planning with Family Limited Partnerships

the transactions by analyzing them against certain financial information constraints such as net income, sales and transaction value to determine how much these factors affect the discount. Further filtering of the transactions was made by eliminating the bank and REIT transactions. Johnson stressed that the stocks examined in his study were only restricted for two years – a privately-held business is a non-marketable interest with no expectations of being publicly-traded in the future.

The *Columbia Financial Advisors, Inc. Studies* (2000) was the first study to address the change in restricted stock discounts resulting from two key events that increased the liquidity of these securities. First in 1990 the SEC adopted rule 144A, which relaxed the SEC filing restrictions on private transactions and, then in 1997, the holding period requirements under Rule 144 were amended to permit the resale of limited amounts of restricted stock after one year. Additionally, the amendment permits unlimited resale of restricted stock held by non-affiliates of the issuer after a holding period of two years, rather than three years. Transactions with no offer price or public market price available and transactions with non-U.S. issuers that were not traded in the U.S. were eliminated – as a result, only 23 of the initial 123 private placements were analyzed. The mean was 21%, but the median resulted in only 14%. The same methodology was then applied at a later date, which resulted in an average discount of 13% and a median discount of 9%.

The most recent study by *FMV Opinions* (2001) provides a method for determining the appropriate discount for restricted liquid securities and a method for distinguishing which of the discounts are appropriate for privately-held companies, as opposed to restricted stock of public entities. The study calculated an overall average discount of approximately 22%. The median discount for securities traded over-the-counter is 22.4%, which was 7.1% higher than securities traded on an exchange.

There was a tendency for companies with the largest sales volumes to receive the smallest discounts, and the companies with the smallest sales volumes to receive the largest discounts. This is believed to be a result of the trading market. For example, the discounts on the letter stocks were the least for New York Stock Exchange (“NYSE”) listed stocks, and increased, in order, for American Stock Exchange (“AMEX”) listed stocks, Over-the-Counter (“OTC”) reporting companies, and OTC non-reporting companies. A non-reporting OTC company is a company whose stock is publicly-traded over the counter but is not subject to reporting requirements because its total assets are under \$1 million or it has total stockholders numbering 500 or fewer. Non-reporting OTC companies are believed to most nearly resemble closely-held companies.

The decrease in the discounts associated with the more recent restricted stock studies can be attributed to both the increase in volume of privately-placed stock under SEC Rule 144(a), as well as the change in the minimum holding period under Rule 144.



Realities of Estate Planning with Family Limited Partnerships

FMV Restricted Stock Database and the Restricted Stock Equivalent Analysis

In cases including *Estate of Temple* (No. 903-CV-165) and *Estate of Peracchio* (T.C. Memo. 2003-280), courts rejected the use of average study results in favor of a more-detailed analysis. As a result, the Restricted Stock Equivalent Analysis and the FMV Restricted Stock Database have gained popularity in the valuation community.

Business valuation theory suggests that risk as a function of size, profitability, dividend distribution, and liquidity are some of the most important factors in determining the level of marketability discount applicable to restricted stock transactions and for privately-held equity transactions. As previously noted, analyses indicate that a company's risk generally increases with smaller (asset and revenue) size, lower profits, and the inability to transfer shares, which causes the discount for lack of marketability to increase. Further analyses focused on the type of companies and their profitability indicate that financial companies (including investment holding companies) and profitable companies experienced significantly lower discounts.

The *FMV Restricted Stock Database* includes over 597 restricted stock transactions with 55 data fields that can be searched for companies with similar characteristics to the subject family limited partnership to determine the discounts applicable to restricted stock transactions. A search of the database can be performed for restricted stock transactions involving companies with size, profitability and levels of dividend payments similar to the subject family limited partnership. Each variable should be searched independently to determine its impact on the transactions marketability.

Restricted Stock Equivalent Analysis is based on the assumption that there are inherent and significant differences between the liquidity of restricted stock and the liquidity of private equity. The analysis is completed in a two-step process, which includes determining the restricted stock equivalent discount, given the financial characteristics of the entity, and then an incremental discount for the privately-held entity based upon the review of the most illiquid restricted stock issues. In terms of liquidity, transactions involving large blocks are essentially like private equity.

Pre-IPO Studies

Based on current business valuation theory and recent court decisions the pre-IPO studies will only be mentioned briefly herein.

Robert W. Baird & Company (the Emory Studies) conducted eight pre-IPO studies covering various time periods from 1980 through 1997. The mean discount of the study was 44% and the median was 43%.

The *Emory (Dot-Com) Studies* were an outgrowth of the aforementioned eight pre-IPO discount studies. The study analyzed discounts arising from sale transactions in the 92 IPOs of companies that had “.com” in their names. The mean discount prior to IPO was 54% and the median was also 54%.



Realities of Estate Planning with Family Limited Partnerships

James Hitchner prepared two studies taking the Emory study data a step further. The first *Hitchner Study* analyzed the discounts at which stock and options traded by months remaining to the date of the IPO. The second study used the same breakdown of information as the first study, however, the subject of the analysis changed. The study was based on 23 transactions of 14 consulting industry companies that filed prospectuses between February 1995 and June 1996, and became public companies.

The results of the analyses suggest that the longer the period until a company's IPO, the greater the discount applicable to its stock price. The theory behind the higher discount is, that the longer period remaining until the company's IPO creates more uncertainty that the IPO will actually occur; thus, the stock and/or options trade at a larger discount. The discount is related to the expectation of liquidity of the investment. In the application of discounts for small, closely-held businesses, the argument is made that since there is little or no chance that the company will ever go public, the discounts are at least as high as those calculated in some of these studies.

Willamette Management Associates conducted 12 pre-IPO studies from 1975 to 1993. Average discounts varied, but in all cases, were higher than average discounts shown in the studies for restricted stocks of companies that already had established public trading markets. The standard mean was 37.3%, trimmed mean was 42.2%, and the median was 48.4%. In 1999 and 2000, Willamette Management Associates study resulted in lower median discounts than the average of their previous study. The decrease is believed to be attributed to the height of the dot.com "bubble" that occurred during this two-year period and the average first-day returns for pre-IPO stocks were extraordinarily high.

The *Valuation Advisors' Lack of Marketability Discount Study* is a pre-IPO database with over 8,600 transactions. This database establishes that the further the transaction is from a liquidity event, the higher the discount for lack of marketability. The following summary of recently-added discounts is provided:

<u>Period</u>	<u>2-4 Years</u>	<u>5-8 Years</u>	<u>8+ Years</u>	<u>Total</u>
Median	79.2%	84.7%	90.0%	80.5%
Average	66.2%	76.9%	85.6%	68.0%
Count	1,512	222	43	1,777

As previously noted, valuers tend to focus more on restricted stock studies in quantifying discounts for lack of marketability.



Realities of Estate Planning with Family Limited Partnerships

Mandelbaum Factors

In *Estate of Mandelbaum v. Commissioner*, T.C. Memo 1995-225, Judge David Laro prepared an analysis and provided a listing of factors (below) that impact marketability.

- Financial statement issues
- Dividend policies
- Company history and position and economic outlook
- Management characteristics
- Control inherent in transferred shares
- Transfer restrictions
- Holding period
- Redemption period
- Costs associated with a public offering

Judge Laro also noted that in determining/justifying marketability discounts, appraisers are only considering the willing buyer. In a transaction involving knowledgeable parties with similar information, the transaction price represents a price that both parties believe is fair considering the factors specific to the interest being valued. No one discount for lack of marketability analysis is a perfect representation of the hypothetical transaction of a limited partner interest, however, analyses should confirm that a discount is applicable in a real world transaction; that discounts for lack of marketability are not isolated to just restricted stocks; and the similarities with respect to the lack of marketability of those securities provide a base from which to determine a discount for the subject family limited partnership.

Securities-Based Approaches

Securities-based approaches are based on option pricing models and from observing illiquidity demonstrated by stock prices, such as the bid-ask spread method and option prices such as long-term equity anticipation securities (LEAPS). These methods are not widely used in the valuation of closely-held businesses and have not been vetted in any meaningful way by the courts. Therefore, this material will not provide further detail on securities-based approaches.

Analytical Approaches

The analytical approach category includes studies that investigate those circumstances surrounding, and the results of, a private placement of unregistered or registered (or both) stock in bulk. The studies make the assumption that registered shares have a marketability discount of zero. Therefore, to quantify the marketability discount, the studies compare the total discount per share for the private placement of unregistered shares to that of registered shares.



Realities of Estate Planning with Family Limited Partnerships

Where significant blocks of stock in private placement are involved in comparison to normal daily trading volumes, an element of blockage, as well as marketability, may be present. The studies, nearly all prepared by members of academia, and only one analytical approach (Bajaj et al), have been referred to in court cases including *Estate of Gross* (2001 U.S. App. LEXIS 24803) and *Estate of McCord* (112 T.C. No. 13); however, the approach has met criticism by members of the valuation community.

Other Approaches

Other approaches to the discount for lack of marketability include the *Quantitative Marketability Discount Model (QMDM)* developed by Z. Christopher Mercer, *Frazier's Nonmarketable Investment Company Evaluation (NICE)*, *Tabak's CAPM-Based Approach to Calculating Illiquidity Discounts*, and *Partnership Profiles*. The QMDM calculates a matrix of discounts for lack of marketability based upon a range of variables, including rate of appreciation of assets, holding period until liquidation, and required rate of return of the hypothetical investor. The valuator estimates which variables are most appropriate for the subject interest under valuation. The intersection of those variables within the matrix yields the discount. The model is available at www.mercercapital.com.

In the context of valuing family limited partnerships holding real estate, information developed from Partnership Profiles is relevant. The secondary market differs from a freely-traded stock on a public market, such that there are very limited transactions occurring, which subjects an investor to considerable risks and opportunity costs. The discounts derived from the secondary market provide a combined discount for lack of control and lack of marketability. This is a very important aspect in developing discounts that must be understood by both the valuator and user of the valuation.

An independent company, Partnership Profiles, Inc., located in Dallas, Texas, administers a database summarizing transactions of ownership interests in limited partnerships that are publicly-traded on a secondary market. While the study does not identify a specific discount allocable to minority ownership attributes and lack of marketability attributes, it does offer reasonable insight into underlying cost to fair market value discounts.

In order for the discount data to be relevant, two common elements must apply, regardless of the type of ownership entity. First the interest being valued must be a non-controlling interest, meaning the holder cannot control or influence management decisions solely; and second, the interest must have marketability issues. Such factors are typically present with respect to the valuation of a limited partner interest in a family limited partnership.

The results of the discount study reveal that the most important factor considered by secondary market buyers in "pricing" units of real estate partnerships is whether the partnership is paying regular cash distributions. Two other important factors that have an impact on the price-to-value discounts buyers extract from sellers include (I) the type of real estate assets held by the partnership and (II) the degree of debt encumbering the partnership's assets.



Realities of Estate Planning with Family Limited Partnerships

According to the *2011 Executive Summary Report on Partnership Re-Sale Discounts* by Partnership Profiles, Inc., speculators in the limited partnership secondary market were purchasing units in real estate partnerships at an average price-to-value discount of 33%. The same average discounts for 2006, 2007, 2008, 2009, and 2010 were 29%, 27%, 25%, 28% and 29%, respectively. It is important to note that the price-to-value discounts have decreased since the mid-'90s. In more recent years the decline can be attributed to buyers anticipating near-term liquidations, even for partnerships that have not announced any plans for liquidation.

All of the partnerships are publicly-registered with the Securities and Exchange Commission, but none of the partnerships are publicly-traded on any formal exchange. Instead, units of the partnerships change hands in the informal partnership secondary market, which is comprised of eight independent firms that primarily act as intermediaries in matching up buyers and sellers of non-traded public partnerships of all types.

The partnerships featured in the study were placed into four distinct categories. The categories and the average discount for each are as follows:

<u>Partnership Profiles – Summary of 2011 Discount Study</u>			
<u>Category</u>	<u>Number of Partnerships</u>	<u>Average Discount</u>	<u>Average Yield</u>
Equity – distributing (low or no debt)	8	17%	7.8%
Equity – distributing (moderate to high debt)	11	32%	7.2%
Equity – non-distributing	21	46%	0.0%
Triple-net-lease	16	19%	8.8%

An additional step can be taken to further refine the results of the study. A search of the Partnership Profiles database can be performed to derive a population of limited partnership transactions that are more closely-aligned with the subject family limited partnership.



Realities of Estate Planning with Family Limited Partnerships

Other Discounts

There are other discounts that may be applicable in the valuation of a family limited partnership, including:

- Market absorption and blockage discounts
- Key person/thin management discounts
- Investment company discount
- Information access and reliability discount
- Investment company discount
- Information access and reliability discount
- Lack of diversification discount
- Non-homogenous assets discount
- Restrictive agreement discount
- Small company risk discount
- Specific company risk discount
- Built-in gains discount
- Liquidation costs discount

Please note that valuers compensate for value detriments differently, and one or more of the aforementioned discounts, if determined they are applicable, may be included in the discount for lack of control or marketability. It is important that the user of the valuation report has an understanding of where these value detriments are being included as to avoid a “double counting.”

It should go without saying that the key for successfully applying (and defending) valuation discounts is to have an understanding of the bundle of rights attendant to the subject interest under valuation. This understanding is derived from review of the family limited partnership agreement and the third-party data used to develop the discounts. The IRS noted in their recent Job Aid on discounts for lack of marketability, “The analyst must get behind the data used to support a DLOM choice rather than simply using summary statistics and resulting conclusions developed by somebody else.”



Realities of Estate Planning with Family Limited Partnerships

Chapter VI – Working Example: Family Limited Partnership Valuation

The following is a working example of selected portions of a valuation prepared to render an opinion as to the fair market value of a 1% limited partner interest in a family limited partnership prepared for estate planning purposes. The valuation date is September 30, 2011. As a result, all information and analyses will be prepared from the perspective of the valuation date.

Background

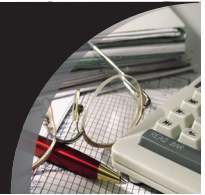
The ABC Family Partners, L.P. (hereinafter “ABC FLP” or “Partnership”) was formed on July 1, 2009, in accordance with *The Uniform Limited Partnership Act* as adopted by the Commonwealth of Pennsylvania. The primary business purpose of the Partnership is to buy, sell, lease, option, rent, operate, mortgage, encumber, own and in any other manner deal with or in property, real or personal, tangible or intangible.

At the valuation date the capital structure of ABC FLP is as follows:

<u>Partner</u>	<u>Partner Interest</u>	<u>Ownership Percentage</u>
ABC, LLC	General	2.0%
Mr. ABC	Limited	50.0%
Daughter ABC Trust	Limited	24.0%
ABC Jr. Trust	Limited	24.0%

Based upon the partnership agreement of ABC FLP, the general partner has the full and exclusive power, in the name and on behalf of the Partnership, to manage the business affairs of the Partnership and have all necessary powers to carry out the purpose of the Partnership. Distributions are made at the sole discretion of the general partner. Additional contributions may be made upon determination by the general partner and with consent of all limited partners. The general partner is not personally liable for the return of capital contributions of the limited partners to the Partnership. The general partner may not assign or otherwise transfer his interest to any person, other than by gratuitous transfer to another general partner (if one is added), without the written consent of all of the Partners.

Limited partners have no authority to act on behalf of the Partnership; have no rights in connection with the management of the Partnership; and may not take any part in the conduct or control of the Partnership’s business and/or assets. The interest of a limited partner is not assignable to any person without the written consent of the general partner and a majority interest of the limited partners.



Realities of Estate Planning with Family Limited Partnerships

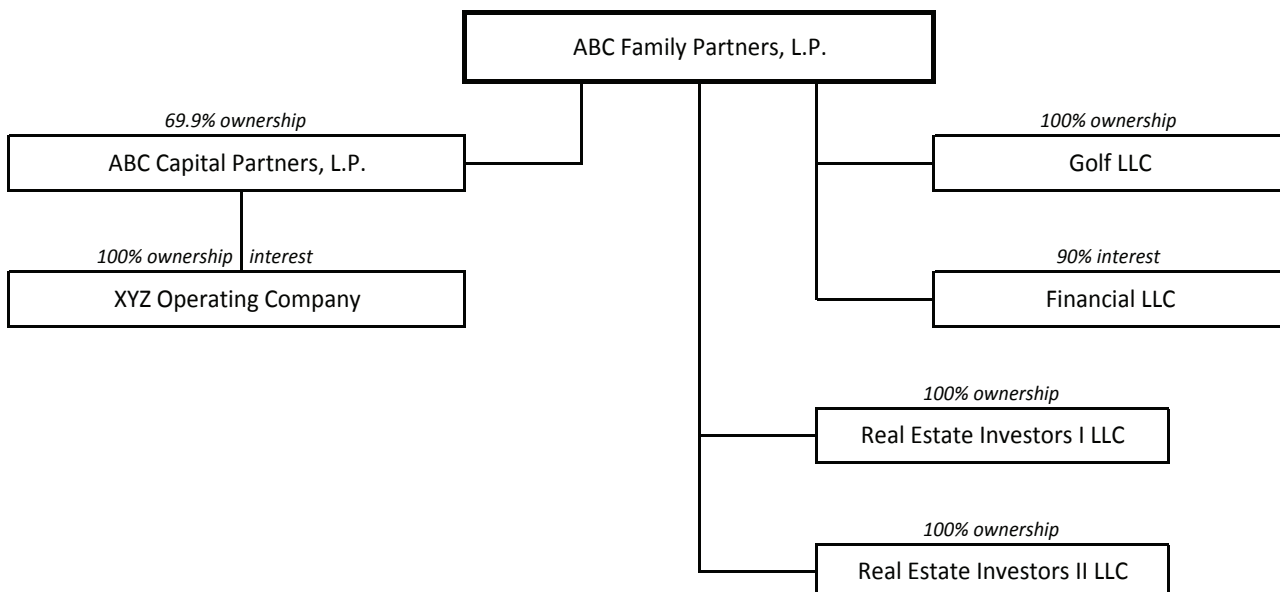
Any Partner may designate a successor in interest of such Partner to take effect upon the death or termination of such Partner. Except in the case of a gratuitous transfer to another general partner, a successor in interest to a general partner may become a general partner only upon the written consent of all the Partners.

A limited partner may be removed at any time upon the affirmative vote of the general partner and a majority in interest of the limited partners. A general partner may never be removed from the Partnership.

The Partnership will not dissolve upon the bankruptcy, death, removal or withdrawal of any Partner. The remaining general partner or general partners have the right to continue the Partnership upon bankruptcy, death, removal or withdrawal of any Partners, and have the ability to liquidate such Partner's interest in the Partnership and make payments to the remaining Partners.

The Partnership may be dissolved upon the occurrence of: the expiration of the term of the Partnership; the agreement of all the Partners to dissolve; the failure to continue the Partnership following a Partner's withdrawal or removal; or the bankruptcy, withdrawal or death of all of the general partners, unless all the remaining Partners agree to accept a designated successor as a general partner or elect one or more general partners within 180 days following the occurrence of the event causing the dissolution. Upon dissolution of the Partnership, the Partnership assets will be liquidated and used to pay all Partnership debts, liabilities and obligations in the order of priority. All remaining assets will be distributed solely to the Partners in proportion to the positive balances in their respective capital accounts. At the time the last distribution is made, the Partnership will terminate.

ABC FLP has the following organization structure at the date of valuation:





Realities of Estate Planning with Family Limited Partnerships

Description and Value of Underlying Assets

ABC Family Partners, L.P.'s primary business activity at the date of valuation is acting as a holding company with multiple subsidiaries. The Partnership has subsidiaries that generate rental revenue, as well as an operating subsidiary that generates revenue through operations. At the date of valuation, the Partnership's assets include cash, marketable securities, and investments in subsidiaries (either wholly- or partially-owned). A description of each underlying asset and the determination of the asset's respective market values are described below.

Cash and Cash Equivalents

The company considers all highly-liquid debt instruments with original maturities of three months or less to be cash equivalents. As of the date of valuation, this amount totaled \$10,000.

Investments in Marketable Securities

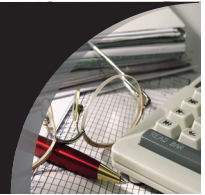
The company holds short-term investments, fixed-income securities, equity securities, mutual funds and alternative investments. These assets are measured at fair value and are considered marketable securities because of their short-term nature. Based upon market values at the date of valuation, the Partnership's investments in marketable securities total \$50,000,000.

Investments in Subsidiaries

The Partnership holds investments in multiple subsidiaries. As previously noted, Real Estate Investors I LLC (Investors I), Real Estate Investors II LLC (Investors II), and Golf LLC are all wholly-owned subsidiaries. ABC Capital Partners, L.P. (Capital L.P.) and Financial LLC are partially-owned subsidiaries.

Wholly-Owned Subsidiaries:

- Investors I holds cash in the amount of \$100,000 as well as real estate. The real estate consists of land and buildings owned at three locations in Pennsylvania. The real estate was appraised by a third-party appraiser and has a value of \$14,900,000. There are no liabilities encumbering the assets and, therefore, at the date of valuation, the underlying assets of Investors I total \$15,008,000.
- Investors II holds assets including cash in the amount of \$100,000 and real estate. The real estate holdings, all located in Pennsylvania and acquired in 2008, include two buildings and two plots of land that are considered developed residential property, which is held for lease. The real estate was appraised by a third-party appraiser and has a value of \$19,900,000. There are no liabilities encumbering the assets and, therefore, at the date of valuation, the underlying assets of Investors II total \$20,000,000.



Realities of Estate Planning with Family Limited Partnerships

- Golf LLC operates a golf course in Arizona. The golf club was appraised by an independent third party in early 2011. The appraised value of the golf course is \$10,000,000, and after the reduction for liabilities totaling \$5,000,000, the value of the Partnership's investment in Golf LLC is \$5,000,000.

Partially-Owned Subsidiaries:

- The Partnership holds a 90% interest in Financial LLC. Financial LLC holds cash and receivables. Total assets are \$1,111,111 at September 30, 2011. There are no liabilities at the date of valuation. The value of the Partnership's investment in Financial LLC is derived by calculating its share of Financial LLC's net asset value. The value of the Partnership's investment in Financial LLC at the date of valuation is \$1,000,000 ($\$1,111,111 \times 90\%$).
- The Partnership holds a 70% interest in ABC Capital. ABC Capital's assets include cash in the amount of \$10,000, office furniture appraised at \$25,000, and an investment in a wholly-owned subsidiary, XYZ Operating Company. XYZ is an operating entity in business as an industrial contractor. Since XYZ Operating Company is an operating business, the value was determined using an income approach and, specifically, a discounted cash flow model. The value of XYZ Operating Company was determined to be \$25,000,000. After the reduction of liabilities, the value of ABC Capital is \$20,000,000. The value of the Partnership's investment in ABC Capital is \$14,000,000.

Multi-Level Discounts

Since ABC FLP holds controlling interests in all of its subsidiaries, there will be no adjustment made for lack of control attributes. There is no market for a controlling or fractional equity interest in a privately-held entity. If the buyer needs cash, he or she would most likely not be able to sell such an interest, except at a substantial discount. A controlling interest equity sale may face any or all of the following complications, which generally do not occur in transactions of truly-liquid and marketable securities.

- Uncertain time horizon to complete the offering or sale
- Cost to prepare for and execute the offering or sale
- Risk concerning eventual sale price
- Noncash and deferred transactions proceeds
- Inability to hypothecate (i.e., the inability to borrow against the estimated value of the stock)⁴

As a result, in order to compensate for the illiquidity of ABC FLP's controlling interests in its subsidiaries, a 10% discount is applied to the value of each subsidiary at the lower-tier level.

⁴ Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweih, Valuing a Business, 4th ed. (New York, McGraw-Hill, 2000), pp. 412-413



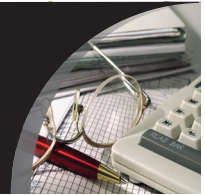
Realities of Estate Planning with Family Limited Partnerships

Cost/Asset Approach

A knowledgeable investor of a general partner interest in the Partnership, based upon historical financial data and the Partnership Agreement, would be aware that the benefit of an investment in the Partnership would likely be through the appreciation of the underlying assets. Therefore, the cost/asset approach is applied.

As of the valuation date the fair market value of the Partnership's equity is as follows:

ABC FAMILY PARTNERS, L.P. – COST/ASSET APPROACH (SEPTEMBER 30, 2011)		
<u>Assets</u>	<u>Market Value</u>	<u>Percentage of Assets</u>
Cash and Cash Equivalents	\$ 10,000	0.01%
Investments in Marketable Securities	50,000,000	50.25%
Investments in Subsidiaries:		
Investors I	13,500,000	13.57%
Investors II	18,000,000	18.09%
Golf LLC	4,500,000	12.66%
Financial LLC	900,000	.90%
ABC Capital	12,600,000	4.52%
Total Assets	<u>\$ 99,510,000</u>	<u>100.00%</u>
<u>Liabilities</u>		
Note Payable – Long Term	<u>\$ 25,000,000</u>	<u>25.12%</u>
Total Liabilities	<u>\$ 25,000,000</u>	<u>25.12%</u>
Net Asset Value – Equity	<u>\$ 74,510,000</u>	
Pro-Rata 1% L.P. Interest	<u>\$ 745,100</u>	



Realities of Estate Planning with Family Limited Partnerships

Valuation Discounts

Discounts for lack of control and lack of marketability will be applied by asset type or class and are based upon data that reflects similar characteristics of each underlying asset. Note that discounts will not be applied to the cash held by the Partnership.

Discounts for Lack of Control

Mergerstat® Review was used to develop the discount for lack of control attendant to the Partnership's investment in ABC Capital, Financial LLC and Golf LLC. Based upon calculating the inverse of the median control premium using industry-specific data from Mergerstat® Review, the discounts are calculated at 20% for ABC Capital and Financial LLC, and 25% for Golf LLC.

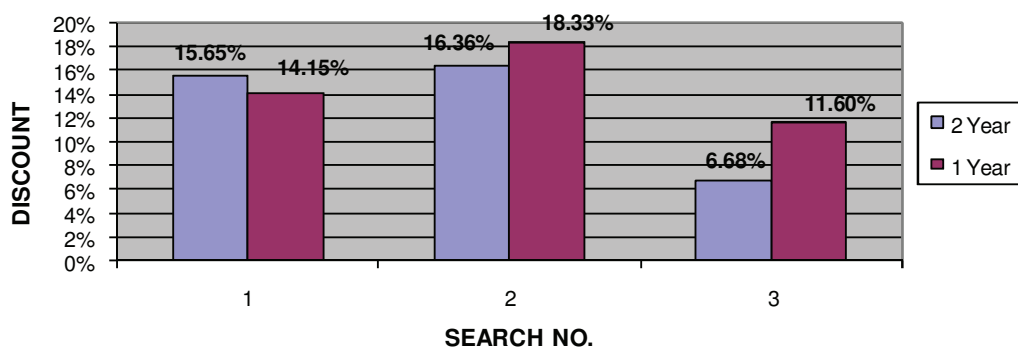
An analysis of closed-end funds was undertaken in connection with the Partnership's marketable securities. Based upon a search of the Morningstar Closed-End Fund database that included type (domestic equities, fixed income, international stock) and industry (energy, financial, health care, and utilities), the minority discounts is 6%.

Discounts for Lack of Marketability

The discount for lack of marketability was developed using the FMV Restricted Stock Study database. Three separate searches were performed for restricted stock transactions involving companies with a similar assets size, similar pre-tax profits and companies making distributions.

The following table illustrates the results from the three searches described in the preceding paragraphs.

**THE FMV RESTRICTED STOCK STUDY DATABASE
SEARCH RESULTS**



The median discount based upon the three limiting criteria is 15.65%, for transactions prior to April 29, 1997. The discount for lack of marketability is rounded to 16%.



Realities of Estate Planning with Family Limited Partnerships

The discounts applicable to the real estate entities, Investors I and II, will be based upon the secondary market real estate market as derived from Partnership Profiles. The discounts derived from the secondary market provide a combined discount for lack of control and lack of marketability. The discount is based on the 2011 discount study using equity-distributing partnerships with low or no debt. The average combined discount is 17%.

Based upon the discounts developed, the overall valuation adjustment applicable to a 1% limited partnership interest is calculated on a weighted average method, illustrated as follows:

ABC FAMILY PARTNERS, L.P. RECONCILIATION OF DISCOUNTS					
<u>Asset</u>	<u>Discount for Lack of</u> <u>Control Marketability</u>		<u>Combined</u>	<u>Weight</u>	<u>Weighted</u> <u>Discount</u>
Cash	0%	0%	0%	0.01%	0.00%
Investments in:					
Marketable Securities	6%	16%	21%	50.25%	10.55%
Real Estate	*	*	17%	31.66%	5.39%
ABC Capital Partners, LP	20%	16%	33%	12.66%	4.18%
Financial LLC	20%	16%	33%	0.90%	0.30%
Golf LLC	25%	16%	37%	4.52%	<u>1.67%</u>
Total					<u>22.09%</u>
Rounded					<u>22.00%</u>
* Partnership Profiles database produces a combined discount					

Based upon the application of valuation adjustments applicable to the 1% percent limited partner ownership interest, the fair market value is illustrated as follows:

ABC FAMILY PARTNERS, L.P. CALCULATION OF FAIR MARKET VALUE OF LIMITED PARTNERSHIP INTEREST	
Pro Rata Value of the Net Asset Value (see page 59)	\$ 745,100
Less: Combined discount (22%)	<u>(163,922)</u>
Value of a 1% Limited Partner Interest	<u>\$ 581,178</u>
Rounded	<u>\$ 581,000</u>



Realities of Estate Planning with Family Limited Partnerships

Chapter VII – Recent Court Cases Relating to Family Limited Partnerships

The following is a presentation of recent court cases (not intended to be all-inclusive) involving family limited partnerships. The cases are separated by issue, including tiered-entity discounts, Section 2036, and valuation methods.

Tiered-Entity Discounts and Miscellaneous Discounts

Astleford v. Commissioner, T.C. Memo 2008-128, Docket No. 4342-06 (May 5, 2008)

- Purpose of the valuation was to calculate the fair market value of three 30% limited partnership interests in Astleford FLP (AFLP)
- AFLP owned a 50% GP interest in Pine Bend Development Co., and ownership interest in an elder-care assisted living facility and 14 other parcels of real estate
- IRS challenged valuation of gifts on 1997 tax return
- At trial, six valuation analysts presented their opinions on FMV (four experts for petitioner, two for IRS) – all used net asset value and considered discounts at upper tier
- Value of Rosemount Property (1,187 acres of Minnesota farmland)
 - Taxpayer expert: \$3,100/acre using sale transactions; 25% discount rate; FMV of \$1,817/acre
 - IRS expert: \$3,500/acre using sale transactions; 9.2% discount rate deemed appropriate but not applied
- Value of Pine Bend GP Interest
 - Taxpayer expert: valued as assignee interest; applied 5% discount, plus combined 40% DLOC/DLOM using 17 publicly traded RELPs
 - IRS expert: no discount (treated as GP interest, not assignee interest); rejected both DLOC & DLOM
 - Explained that partnership interest was simply an asset of AFLP; thus did not need any additional discounts at this level
- AFLP Net Asset Value
 - Taxpayer expert: DLOC of 45% and 40% for two valuation dates based on RELPs; DLOM of 15% and 22% at two valuation dates
 - IRS expert: DLOC 7.14% and 8.34% for two valuation dates based on REITs, DLOM of 21.23% and 22.0% at two valuation dates

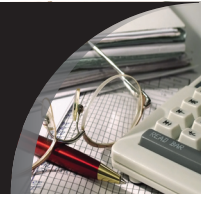


Realities of Estate Planning with Family Limited Partnerships

- Tax Court Opinion
 - Rosemount property: agreed with IRS analyst with pre-discount value of \$3,500/acre, but sided with taxpayer's analyst's DCF; applied discount rate of 10% with implied market absorption discount of 20.4%
 - Pine Bend interest: applied combined discount of 30% at lower tier based on taxpayer's expert's RELP data
 - AFLP: accepted general method applied by IRS expert
 - Calculated liquidity premium of 16.27% from REIT data, resulting in DLOC of 16.17% and 17.47% for two valuation dates
 - DLOM of 21.23% and 22.0%, as applied by IRS expert
- Summary
 - Court accepted significant discounts at both upper and lower tiers
 - Court provided rationale for appropriateness of applying layers of valuation discounts
 - Based on whether lower tier assets constitute a significant portion of the parent company's assets

Keller v. United States, 2009 WL 2601611 (S.D. Tex.), August 20, 2009

- Widow funded FLP with \$250 million in corporate investment bonds
- Set up a LLC as to 0.1% GP; two family trusts holding 49.95% interest would be LPs
- Widow died before she was able to transfer assets or capitalize the GP interest, but had given advisors direction to complete the FLP
- Advisors set up FLP approximately a year after her death and filed amended estate tax return using discounted values, claiming a tax refund
- The Court ruled that the FLP was valid under Texas state law prior to the widow's death despite the failure to fund; as such, it fell within exceptions of IRC Sec. 2036(a) and 2038(a) as "bona fide sale for adequate and full consideration"
- The Court adopted the taxpayer's appraised values of the estate including a combined 47.5% discount



Realities of Estate Planning with Family Limited Partnerships

Dawkins v. Hickman Family Corp., 2011 WL 2436537 (N.D. Miss.), June 13, 2011

- Plaintiff filed a verified complaint for dissolution and temporary and preliminary injunctive relief against Hickman Family Corporation
- Plaintiff desired payment for 37.5% combined minority interest but declined to submit evidence regarding the fair value of shares
- Defendant had a business valuation performed to provide a fair value for plaintiff's shares in the FLP (fair value being without consideration for discounts for lack of control or marketability)
- Plaintiff disputed appraiser's value – partially due to his accounting for a potential tax liability
- Court sided with defendant stating that inclusion of the built-in capital gains was correct, and application of a dollar-for-dollar discount to account for tax liability was also appropriate

Murphy v. U.S., 2009 WL 3366099 (W.D. Ark.), October 2, 2009

- CEO and controlling stockholder, Mr. Murphy, set up a FLP to pool and grow family's wealth
- Mr. Murphy created an LLC as the GP; he took a 49% interest for himself and gave his two kids a combined 51% interest
- Mr. Murphy transferred \$89 million in Murphy Oil stock, timber, banking securities and real estate holdings to the FLP
 - Transfer represented only 50% of total wealth
 - After formation and funding, Mr. Murphy owned 95.2% LP interest in FLP
- Mr. Murphy died unexpectedly in 2002, and his estate, which exceeded \$135 million, paid over \$46 million in taxes
- The IRS cited \$34 million in deficiencies, most of which related to FLP transfers
 - Estate lacked liquidity to pay assessments, as remaining assets were tied up in the FLP's noncontrolling, non-marketable interests
 - Estate borrowed from children's trusts to pay and sued the IRS for a \$41 million refund
- Court found that FLP was created for a legitimate non-tax business purpose: to pool family assets for investment, protect assets, pass the management responsibility to the next generation, etc.



Realities of Estate Planning with Family Limited Partnerships

- Both valuation experts applied net asset value approach, applied Rule 144 and blockage discounts, and discounts for lack of control and lack of marketability
- Court adopted the estate's expert's Rule 144/blockage discounts for underlying assets, as it was deemed more credible – assessed qualitative factors such as stock volatility, actual price changes, financial outlook and earning trend of company, transfer restrictions
- Court applied the estate's expert's discount for lack of control (12.5%), as his analysis was more detailed and credible – used closed-end funds, Partnership Profiles
- Court adopted the estate's expert's discount for lack of marketability (32.5%) – both experts used restricted stock studies to determine DLOM
- Court determined fair market value of 95.2% LP interest to be \$74.5 million and ordered a complete tax refund

Section 2036 issues

Giaimo v. Vitale, 2011 WL 1549064 (N.Y. Sup.), April 25, 2011

- Brother and sister owned equal interest in a FLP that owned and operated 19 Manhattan apartment buildings
- Brother elected to buy out sister's shares – had 50% interest valued by "special referee," using fair value standard
 - No discount for lack of marketability (DLOM)
 - Applied present value discount for built-in gains (BIG) tax liability
- Trial court adopted findings of referee – both parties appealed based on application of discounts to fair value
- Both parties' experts used net asset value approach – argued application of DLOM and BIG discount
- Court rejected petitioners and endorsed the findings of the special referee – applicability of BIG discount, but not DLOM



Realities of Estate Planning with Family Limited Partnerships

Estate of Black v. Commissioner, 133 T.C. 15 (December 14, 2009)

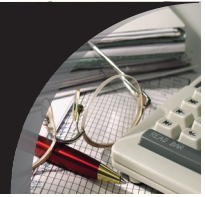
- Mr. Black was the second-largest shareholder in Erie Indemnity Company
- Created FLP holding 1% GP interest as the managing partner; son and two grandsons' trusts held LP interests
- FLP was funded entirely with Erie stock held by Mr. & Mrs. Black; son also contributed all the stock he held
- From 1993 to 2001 the FLP:
 - Saw net asset value rise from \$80 million to \$318 million
 - Acquired and operated commercial real estate
 - Distributed 92% of the dividends it received on the Erie stock
 - Purchased shares in the son's insurance business
- Mr. Black died in 2001, followed soon after by Mrs. Black
- In the estate's tax return, the IRS noted four deficiencies, totaling over \$83 million
 - All issues were resolved between parties except a Section 2036(a) issue: did contributions of stock to FLP constitute bona fide transfers for adequate consideration sufficient to value the FLP interests at FMV (with discounts) for estate tax purposes?
- Taxpayer claimed:
 - FLP adhered to buy-and-hold investment philosophy
 - Transfer restrictions prevented son from selling or encumbering the stock, even when trusts terminated
 - Consolidated position of family allowed them to maintain a seat on the Erie board of directors
 - FLP protected son's stock during a divorce; his wife received only 125,000 shares the son had pledged for a personal loan
- Taxpayer relied upon 2005 *Schutt* case – Tax Court acknowledged that the “mere holding of an untraded portfolio in marketable securities” is a negative factor in its assessment of an FLP's non-tax purpose
- Court found that Mr. Black's desire to preserve the Erie holdings within his family was a sufficient, legitimate, non-tax reason to form the FLP and satisfied the “bona fide” language of the 2036(a) exception
 - FMV of Mr. Black's partnership interest in Black LP, not the FMV of the Erie stock he contributed, is includible in gross estate



Realities of Estate Planning with Family Limited Partnerships

Estate of Turner v. Commissioner, WL 3835663, (August 30, 2011)

- Mr. and Mrs Turner set up the FLP so that each owned a 0.5% GP interest and a 49.5% LP interest, before transferring any LP interests
- Contributed assets consisted of 60% stock from a family-held bank, as well as fixed income investment accounts, cash and certificates of deposit, all totaling approximately \$8.7 million
- The Turners retained \$2 million to cover all their personal living expenses
- The Turners' attorney used a standard form to organize the FLP; some of the language in the agreement was not applicable to the Turner's FLP
- Three specific purposes of agreement included 1) to make a profit; 2) to increase wealth; and 3) to provide a mechanism for family members to be more knowledgeable about finances
- An additional provision required GP to pay the FLP operating expenses personally – in reality, the Turners paid themselves a management fee expense from which they paid the operating expenses
- When transferring LP interests, an appraisal was performed to determine the fair market value of the LP gifts
- Upon Mr. Turner's death two years after the gifting, value of his LP interest was derived from original appraisal
- An appraisal was performed to file the estate return, which valued Mr. Turner's GP and LP interests at \$31,000 and \$1.6 million, respectively
- The IRS assessed a deficiency under IRC 2036, claiming all the FLP assets should be included in the estate
- Court found that the FLP fell short of meeting the "bona fide" sales exception of IRC Section 2036(a):
 - With regard to the stated purposes of the FLP, the assets contributed to the FLP did not require active management or special protection, nor did the assets change form substantially during operation
 - Mr. Turner did not intend to perpetuate any unique investment philosophy
 - The FLP was not set-up to resolve family discord
 - The family did have a troubled grandson, however, there was a separate trust for him, which protected against potential dissipation of assets
 - Mr. and Mrs. Turner commingled personal and partnership funds to pay management fees to pay for estate planning, as well as the premiums on the children's trust life insurance policy
 - Husband and wife did not complete funding for the FLP until eight months after its formation
 - Prior to trial the parties stipulated to the net asset value of the FLP assets at \$9.58 million



Realities of Estate Planning with Family Limited Partnerships

Estate of Shurtz v. Commissioner, 2010 WL 374528 (U.S. Tax Ct.) (Feb. 3, 2010)

- Husband and wife donated to charity substantial sums of money from Mrs. Shurtz's independent wealth (she owned a 16% LP interest in her family's timber company and 780 acres of prime Mississippi timberland)
- Mr. and Mrs. Shurtz formed a FLP to preserve their estate
- Mrs. Shurtz transferred 6.6% interest in Mississippi timberland to husband, who put it in the FLP for a 1% GP interest
- Mrs. Shurtz then transferred the remaining Mississippi timberland into the FLP, along with the 16% LP interest in the family timber company, in exchange for a 1% GP interest and a 98% LP interest in the couple's FLP
- Mrs. Shurtz gifted numerous interests to her children and grandchildren from 1996-2002, reducing her LP interest to 87.6%
- At her death in 2002, the LP interest was valued at just under \$6.1 million, and her GP interest at \$73,500
- Estate plan disbursed nearly its total value to qualified marital and other trusts; claimed no taxes were due
- The IRS wanted to tax the full value of the FLP assets; taxpayer claimed the Section 2036 exemption applied
- The Tax Court looked at the following factors:
 - The Shurtzes had a legitimate concern to protect their family's assets from creditors
 - The FLP facilitated the management of the timberland by holding regular meetings in conjunction with the family timber business and helped to actively manage the business
 - The FLP conducted regular business with respect to the timberland including annual amortization of expenses and a realized gain from a 1997 harvest
 - The partners received interests in the FLP proportionate to their ownership contributions, and their accounts were properly adjusted over time
- The Tax Court found that the formation and funding of the Shurtz FLP constituted a bona fide business
 - The transfers then fell within the Section 2036 exception, and the fair market value of the FLP interest, rather than the fair market value of the contributed property, was includible in her gross estate
 - The Court found that no additional taxes were due



Realities of Estate Planning with Family Limited Partnerships

Estate of Liljestrand v. Commissioner, Tax Ct. Memo LEXIS 251 (November 2, 2011)

- Upon retirement in 1978, a doctor exchanged his interest in a Hawaiian hospital for several real property holdings and formed a revocable trust to hold the property, appointing his eldest son as the trustee
- In 1996 the doctor wanted to plan his estate on behalf of his four children, and wanted to make sure his eldest son remained in position managing the real estate businesses
- The doctor formed a FLP funded with the trust-owned properties (appraised at roughly \$6 million), naming himself a 99.8% GP and his eldest son a class A LP
- Over the next two years the doctor gifted class B LP units to four trusts established for each of his children
- At the date of formation (1997) an appraisal firm appraised the assets – the class A LP units were valued at \$2.14 million, while the class B units were valued at \$5.91 million
- The parties ignored the appraisal and valued the GP units at \$59,000; the class A LP units at \$310,000 ;and the class B LP units at \$2 million – it is unclear how the parties valued these interests
- The parties ignored the formalities of the FLP and its operations until 1999, when they treated the father's former revocable trust as the owner of the real estate; used its bank account; and filed real estate income on the father's personal tax returns
- In 1999 the family's accountant filed a return for the FLP, but did not amend prior returns, rather treating the FLP as having commenced operations in 1999
- The FLP made disproportionate distributions; loaned the eldest son money without requiring a promissory note or expecting to be repaid; and upon the doctor's death in 2004, refinanced certain properties that it owned, using the proceeds to pay the father's estate taxes of \$2.3 million
- In 2008 the IRS assessed a \$2.6 million deficiency, based on including the entire fair market value of the father's real estate holdings in his estate; taxpayer petitioned the court for a determination of the liability
- The estate claimed that the FLP had at least three legitimate, non-tax business purposes:
 - Ensured the son's continued employment as the manager of the real estate, preventing a conflict of interest that would exist had he continued to manage the properties and been the trustee of the revocable trust
 - Protected the FLP assets from partition
 - Protected the FLP from creditors



Realities of Estate Planning with Family Limited Partnerships

- In response the IRS noted the following:
 - The formation of the FLP simply changed the nature of the trust's holdings from directly owning the real property to owning FLP interests with the son becoming a GP – this did not resolve the conflict of interest or change his roles with respect to the trust
 - Most properties were outside of the reach of Hawaiian trust laws, and the doctor's estate planning attorney never researched the application of trust laws in those other states – this lack of research is telling as to the significance of the threat of partition in the decision to form
 - The estate failed to name a single potential claim, or even establish a pattern of activity by the partners, that could expose them to liability
- The Court found that the FLP failed to follow even the most basic partnership formalities, such as keeping regular books and meetings, making proportionate distributions, or refraining to pay the doctor's personal expenses from Partnership assets
- The Court also found that the father funded and formed the FLP without any evidence that he held arm's-length negotiations with the other partners
- The Court found that the transfers were not for full and adequate consideration, as the parties ignored the original appraisal and did not have a bank account to deposit contributions by partners; it also did not find any evidence of the son making a contribution in exchange for his GP interest
- Taking into account these factors, the Court included the full fair market value of the FLP assets in the father's gross estate and denied the estate's petition

Holman v. Commissioner, 2010 WL 1331270 (C.A. 8) (April 7, 2010)

- The Holmans created a FLP to preserve their substantial holdings of Dell stock for the benefit of their children, particularly to protect against claims of creditors and to encourage wealth management skills
- The FLP precluded transfers to outside parties and gave the Partnership a right to buy-back any proposed assignments
- The parents (general partners) had exclusive control over the management and investments of the FLP assets
- The IRS argued, and the Tax Court found, that the transfer restrictions did not serve a bona fide business purpose; rather were only used to give children the gift at largely-reduced value



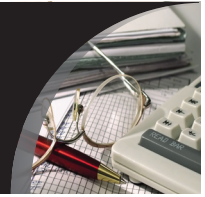
Realities of Estate Planning with Family Limited Partnerships

- Holman's (parents) arguments:
 - Tax Court's definition of 'bona fide business arrangement' was too limited and effectively required that the FLP function as an operating business unit
 - The nature of the assets is irrelevant for determining whether transfer restrictions constituted bona fide business arrangement – the Partnership was an enterprise with the business purpose of generating profits through long-term growth
- Court findings:
 - The FLP was no different from a partnership that holds passbook savings account, government bonds, or simply cash – FLP was absent of an actual business
 - The FLP was just an asset container; had no business purpose; and was predominantly for purposes of estate planning, tax reduction and wealth transference
- Holmans (parents) also appealed DLOM:
 - Taxpayer's expert studied sample transaction with median and median discounts of 24.8% and 27.4 %, and concluded that qualitative differences justified DLOM of 35%
 - The IRS expert examined restricted stock data from two windows: 1972-1990 and 1990-1997, with mean discounts of 34% and 22%, respectively, and concluded that the 12% difference reflected appropriate DLOM, and any remaining portion would be due to specific, holding-period restrictions not otherwise applicable to Holman FLP's shares
- Tax Court adopted the IRS expert's DLOM (12.5%), stating under "willing buyer-willing seller," that a seller would not 'leave money on the table' by transferring largely below market value

Valuation Methods

Estate of Giustina v. Commissioner, WL 2516168 (U.S. Tax Court) (June 22, 2011)

- Oregonian man owned a 41.1% interest in longtime family-owned limited partnership that held large tracts of local timberland
- Upon his death, a national valuation firm appraised his estate at \$12.67 million
- The IRS said the interest was worth closer to \$36 million and assessed a deficiency of \$12.66 million, as well as an accuracy-related penalty of over \$2.5 million



Realities of Estate Planning with Family Limited Partnerships

- Upon appeal, the estate hired a new expert who valued the interest at nearly \$13 million, while the IRS expert came down to \$33.5 million
- Tax Court believed there were ‘only two appropriate’ methods to value the interest: DCF and net asset value
- The experts agreed that the 48,000 acres of timber were worth \$143 million, which included a 40% discount related to expected delays in selling the large tracts
- The experts differed on weights to each method as well as assumptions in DCF
- Court rejected IRS expert’s DCF approach for three reasons: inconsistency in cash flow estimates and calculation of minority interest value; grew revenues at 3% and fixed the operating expenses; and only relied on most recent year of cash flows, not extended period of time
- Taxpayer’s expert used 5-year historical cash flows, however tax-affected the annual cash flow values, which contradicted his relying on a pretax rate of return, which was challenged by the court
- Court accepted using the risk-free rate from 20-year treasuries, beta-adjusted ERP and small stock ERP (all used by the taxpayer’s expert), but challenged the expert’s specific company risk premium, stating it was too high because an investor could diversify their portfolio against the specific company risk
- Court also accepted a 4% reduction to the discount rate for long term growth
- Taxpayer’s expert calculated PV of cash flows at \$33.8 million using his discount rate
- Court concluded total DCF value of \$51.7 million after applying all adjustments
- Court rejected taxpayer’s DLOM because it focused too heavily on pre-IPO studies and ‘overstated the discount’; court accepted IRS expert’s DLOM of 25%
- Court rejected both expert’s weights of DCF method, stating that the weights should reflect the probability that the partnership would continue as a going concern
- Court stated the partnership could sell assets for \$143 million today (as opposed to \$52 million that would be generated by cash flows), however a 41.1% interest holder would have to create a two-thirds voting block with other members to force the sale
- Court assigned a 75% probability to the partnership continuing as an operating business and applied a 75% weight to their DCF analysis; Court concluded that at this percentage a DLOC was not necessary, as a lack of control was present in this weight; a DLOM of 25% was then added to this method



Realities of Estate Planning with Family Limited Partnerships

- Court assigned a 25% weight to the net asset value approach, which valued the timberlands at \$143 million and other assets at \$7 million; Court also rejected a DLOM, as the \$143 million already included a 40% discount
- Court reached a partnership value of \$27.5 million after applying the weights and discounts
- Court rejected the capitalization of distributions method because it believed the cash earned by the partnership is a more reliable indicator of value than the cash distributed to the partners
- Even though experts found timberland comparables, the Court rejected the use of GPCM because the comparables had other assets and earned income from sources other than their timber sales
- Court dismissed the accuracy-related penalties, as the executor reasonably relied in good faith on the original appraisal, which had been performed using 'reasonable' assumptions



Realities of Estate Planning with Family Limited Partnerships

Chapter VIII – Conclusion and Practical Considerations

A substantial amount of commentary exists on the subject of family limited partnerships. As can be observed from the program content, numerous complexities and issues make the use of these entities a minefield for the unwary. However, properly prepared, designed and implemented, there are few strategic planning alternatives that can provide the significant transfer tax savings of family limited partnerships, while affording a mechanism to centralize management of family assets and facilitate control over the maintenance of the transferred assets in more experienced senior generation family members. In addition, the limited liability protection offered limited partners protects assets beyond the partnership and located elsewhere in the family or retained by senior generation family members.

There are safeguards that can be incorporated into the advisory process to ensure that the family limited partnership that is ultimately created and implemented into an individual or family estate plan has the best possible chance of survival under challenge from the Internal Revenue Service. Owen Fiore, prominent attorney and estate planning specialist practicing in the state of California, authored an article first published in Business Valuation Update in July, 2007, and reprinted in the 2010 Issue of BVR's Guide to Business Valuation, Issues in Estate and Gift Tax, where he set out five steps or factors to consider in the support of family limited partnership viability.

Those steps that can be undertaken should, at a minimum, include the following:

- Plan design – Rather than simply plan around tax avoidance, plan the entity with non-tax business and/or investment purposes.
- Structure – Pay attention to the guidance on structure, implementation and operation of the family limited partnership that is provided within the many judicial decisions that have been published on the subject. The Internal Revenue Service Appeals Settlement Guidelines for Family Limited Partnerships (October, 2006), although heavily redacted, provides practitioners with additional guidance.
- Entity formalities – Consider proper document drafting, timely funding with asset transfers, and operational integrity of the plan and partnership.
- Utilize quality valuers and appraisers – Quality valuation specialists can develop, based on counsel-provided assumptions of value, a credible, well-supported, fair market value appraisal of entity interests upon gift, sale, or death.
- Avoid red flags – The Internal Revenue Service, with the help of the courts, generally considers these elements, in combination, as fatal to the entity:
 - Entity formation is near taxpayer's death
 - Transfer to the entity of all (or nearly all) of taxpayer's assets



Realities of Estate Planning with Family Limited Partnerships

- Funding the entity with personal assets – i.e., a taxpayer's home
- Absence of active involvement or understanding of the family limited partnership and the plan by some or all of the junior generation family members
- No change in investment or business strategy occasioned by the plan
- No pro-rata distributions from the entity to family members, especially in support of the senior generation transferor, or to pay estate tax liabilities at the death of the senior generation transferor

Specific considerations related to the plan development include the need to view the design and implementation of a family limited partnership as a “team” effort between the legal representatives for the client and the business valuator. Clearly, there is no way to facilitate a competent and complete implementation without input from both sides. There are few areas where members of the business valuation community work more closely with legal counsel than in the family limited partnership arena.

To fulfill the obligation of the business valuator as an independent and objective expert, he or she needs to fully understand the many nuances and statutory provisions affecting the valuation of interests in family limited partnerships. While the valuation of any assets is fact-specific, knowledge of the case law affecting these types of entities can be helpful in understanding the position of the tax authorities and how the courts interpret important issues.

In addition, a great deal of the understanding necessary to facilitate a strong and defensible valuation comes from full knowledge and vetting of the facts surrounding each case. This process, of course, is most often the result of ongoing and open communications between the taxpayer, the taxpayer's legal advisors and the business valuers.

The business valuation professionals at Grossman Yanak & Ford LLP have extensive experience in preparing the “qualified appraisals” required by the Internal Revenue Code. In cooperation with our friends in the legal community, we have a great deal of comfort in the manner in which we undertake, prepare and report on valuations of ownership interests in family limited partnerships. We have had few challenges from any tax authority, including the Internal Revenue Service, and we are certain that we can provide valuation services that meet or exceed all expectations, and that are as defensible as possible.

Should you have a need to discuss any of the contents of today's program further, or if you have a specific question regarding how a family limited partnership might be available to meet your client's needs, feel free to contact Bob Grossman at 412-338-9304 or grossman@gyf.com or Melissa Bizyak at 412-338-9313 or bizyak@gyf.com.

We appreciate your attendance at today's program, and we hope the information that was shared will help you as you return to your practices. As always, we greatly appreciate your consideration of our firm for referrals for tax, accounting, technology consulting and business valuation services. Thank you.



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