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The Valuation of Family Limited Partnership Interests

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The Valuation of
Family Limited Partnership
Interests

Steven J. Krekeler, CPA, CFP

An Abstract Presented to the Faculty of the Graduate School of Lindenwood University in Partial Fulfillment of the Requirements for the Degree of Master of Science

December 1998

ABSTRACT

The focus of this report is on using family limited partnerships to reduce wealth transfer taxes. This report will explain how valuation discounts applicable to family limited partnership interests enable wealth to be transferred which avoids gift and estate tax. Furthermore, the report will discuss why some family partnership valuation discounts are accepted by the IRS and others are rejected, including steps taxpayers and their professional advisors can take to increase their chances of success.

Senior family members throughout the U.S. have a growing interest in preserving their wealth for the next generation. Many are not aware that 55% or more of their wealth will disappear without proper lifetime planning. Family limited partnerships are incredibly useful vehicles to avoid this result and accomplish other non-tax objectives. A critical factor in successful wealth transfer planning using family partnerships is engaging experienced professional advisors, including those with legal, tax, and financial appraisal credentials.

The Internal Revenue Service perceives family partnerships as a threat to the U.S. transfer tax revenue base. They have openly stated their goal of reducing or eliminating family partnerships as a wealth transfer vehicle. Towards this end, the IRS has launched attacks against family partnerships on several fronts,

including legal and tax based arguments, valuation adequacy challenges, and legislative attacks, all with varying degrees of success.

This report will explain (1) the factors driving the demand for wealth transfer planning, (2) our system of transfer taxation, (3) the tax and non-tax benefits of family partnerships, (4) family limited partnership valuation methodology, (5) threats to family partnerships, and (6) the future of family partnerships.

The results of this study indicate that, despite IRS threats, taxpayers can achieve great success in accomplishing tax and non-tax objectives using family limited partnerships. There are specific steps taxpayers can take which will increase the odds that their planning and valuation discounts will stand up to an IRS challenge and result in tax savings. Avoiding what the IRS considers "abusive" family partnership situations, engaging a qualified professional appraisal firm to support valuation discounts, and retaining an experienced legal advisor all work to achieve success.

Some experts in the field expect a landmark U.S. Tax Court ruling, or new federal law, to curtail family partnership valuation discounts. In the meantime, there is a tremendous window of opportunity for those who act now.

**The Valuation of
Family Limited Partnership
Interests**

Steven J. Krekeler, CPA, CFP

A Culminating Project Presented to the Faculty of the Graduate School of Lindenwood University in Partial Fulfillment of the Requirements for the Degree of Master of Science

December 1998

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Chapter I

INTRODUCTION

Factors Driving the Demand for Wealth Transfer Planning

There are several key factors creating a surge in the demand for wealth transfer planning. A record number of Americans face the inevitable transfer of their wealth. In addition, there is tremendous amount of wealth which will change hands. Furthermore, the number of wealthy Americans in on the rise. And much of this wealth is in the form of real estate and closely held stock, both of which present special transition planning challenges due, in part, to the illiquid nature of these assets.

The parents of the baby boom generation currently face the need to address wealth transfer planning issues. These individuals range in age from their mid 50's to their mid 70's. Many family businesses were started during the 1950s and 1960s which have grown and prospered over the years. Approximately 33% of all closely held business owners are over age 60 (King 48). These individuals are now facing the numerous challenges associated with passing along wealth. These include an onerous tax on wealth transfer, reaching 55% for taxable estates in excess of $3 million; the fact that transfer taxes call for liquid assets to satisfy the tax liability; the reality that inheritance ("transfer at death") is generally an inefficient way to pass along wealth; and ever shifting tax policy and legislative

agendas that create a need to act when opportunity presents itself (Reeves, et al. 2-51).

The challenges faced by the parents of the baby boom generation have created an awareness on the part of the baby boomers themselves of the need to plan for their estates (King 47). Approximately 30% of the U.S. population, about 76 million Americans, are ages 34 to 52 (42). This group will be the recipients of approximately $6.8 trillion in wealth which will change hands over the next 20 years, with the peak period of distribution expected to be between 2002 and 2011 (Kengor 23).

Studies have shown that baby boomers are accumulating wealth at a faster rate than their parents. One recent study indicated that the number of wealthy Americans is expected to triple over the next 20 years to 7.8 million (47). The strength of the U.S. economy , the sustained appreciation of publicly traded and closely held stocks, and the growth of tax-favored retirement plans have greatly increased the number of wealthy U.S. citizens. Along with this wealth comes the need for wealth-transfer planning.

Much of the wealth in our society has been accumulated through the ownership of real estate and closely held stock. Closely held stock is a business interest which does not trade on a public exchange and whose ownership is dispersed among a few individuals, typically less than 100 (Fishman, et al. 1-1). The most frequently listed assets on estate tax returns reporting assets in excess of $600,000 are real estate and closely held stock (King 47). While these assets may be quite valuable, they are typically illiquid in nature in that they are not readably

convertible into cash. Therefore, funding the transfer tax liability on these types of assets can present a difficult challenge. In some instances, the family is forced to sell off the underlying assets in order to fund the transfer tax liability.

One of the more dramatic examples of forced asset sales due to the lack of estate planning was the 1994 disposition by the Robbie family of the Miami Dolphins. Joe Robbie, former owner of the Miami Dolphins, had amassed a net worth at his death of over $1 billion dollars. Due to the lack of a succession plan, the family was faced with a federal estate tax liability of over half of this amount, forcing them to sell off the football team, with the entire proceeds going to pay transfer tax liability (Kengor 18).

Selling existing assets to fund a transfer tax liability is often a poor strategy, due in part to the emotional toll of parting with a family legacy, and also because the very asset which created family wealth is now gone. In addition, a forced sale of assets to raise cash can result in significantly less proceeds than a sale not under duress. Because estate taxes are due within nine months of the date of death, the family may be forced to sell assets into a buyer's rather than a seller's market.

Lamar Hunt, owner of the Kansas City Chiefs, learned from the Robbie family's woes, and in 1997, transferred 80% of the ownership of the team to his children. "If you wait until you die, there are some huge estate taxes which come due." In addition, he noted that "I have a particular emotional thing of wanting this to go forward as a Hunt operation" (qtd. in Pulliam A1).

Even though he incurred some transfer tax in making the lifetime gifts, Hunt took advantage of valuation discounts to mitigate the tax liability. Valuation discounts are the focus of much of this paper and are a fundamental tool in estate planning. Essentially they allow the pro-rata value of minority interests in certain assets to be measured, for transfer tax purposes, at an amount significantly less than the pro-rata value of the asset taken as a whole. A minority interest is an interest in an entity which constitutes less than a 50% ownership interest in that entity (Houlihan 5).

In addition to benefiting from valuation discounts, Hunt removed the majority of further appreciation in the value of the Chiefs from his taxable estate, preserving millions of dollars for his heirs.

Here are a few other examples of the toll of transfer taxes on the estates of wealthy Americans:

- Elvis Presley had amassed $10 million in assets at his death, of which $4 million went to settle debts and $3 million more went for transfer taxes and legal fees (Kuhn D3).
- Walt Disney lost one-third of his $23 million dollar estate to transfer tax liabilities (D3).

As mentioned previously, there are significant drawbacks to transferring wealth at death ("testamentary transfers") rather than during life ("inter-vivos transfers"). While both types of transfers are subject to the same tax rate structure, it is the manner in which the tax is measured that makes lifetime gifting

more advantageous. Transfer taxes paid at death are "tax inclusive", meaning that estate tax is paid on dollars used to pay the estate tax itself. Moreover, transfer tax paid during life (gift tax) is "tax exclusive", meaning that the tax liability accrues on only that value which is transferred, an amount exclusive of the transfer tax on the gift. Second, transferring assets during life also removes future appreciation on the assets from the transferees taxable estate.

Another advantage of lifetime gifting, and much of the focus of this paper, is the opportunity to capitalize on valuation discounts. Discounts for lack of control and lack of marketability can significantly reduce the value of an asset for purposes of measuring transfer tax liability.

Changing legislative and taxation policy add to the complexity of wealth transfer planning. A 1993 revenue ruling opened the door to significant transfer tax savings through lifetime gifting strategies. Revenue ruling 93-12 legitimized valuation discounts in measuring the transfer tax value of intrafamily transfers. However, at the time of this writing, President Clinton's latest budget calls for significantly reducing the availability of valuation discounts in measuring transfer tax liability (Herman C1). Martin Nissenbaum, national director of personal income tax planning at Ernst & Young in New York, was quoted in the February 4, 1998 edition of The Wall Street Journal as saying that "elimination of these techniques would result in a greater level of taxation of trillions of dollars of assets that are eventually to be transferred from the baby-boom generation to its children" (C1). In the immediate present, the White House proposal is spurring even greater interest in lifetime giving, because the curtailing of valuation

discounts would likely not be effective retroactively, creating a window of opportunity for those who act now. (C1).

The Internal Revenue Service (IRS) has given taxpayers yet another reason not to procrastinate when it comes to making lifetime transfers. Over the last 18 months, the IRS has targeted transfers made near death in an attempt to curtail the benefits of valuation discounts. The IRS cites as precedent a previous Tax Court ruling, Estate of Elizabeth B. Murphy v. Commissioner, TC Memo 1190-472. The memorandum stated that where deathbed transactions are conducted for the primary purpose of securing transfer tax valuation discounts, the transactions are testamentary and should be ignored (Wagner 5). The message is clear: the earlier one starts planning his or her estate, the less will have to be paid to the IRS.

Overview of the United States Transfer Taxation System

The United States transfer tax system consists of a gift tax (on transfers during life), an estate tax (on transfers at death), and a generation skipping tax (applicable to lifetime transfers which by-pass a generation). These three taxes are addressed in Chapters 11, 12 and 13 of the Internal Revenue Code, respectively. Gift and estate taxes are based on cumulative transfers during life and at death, using one tax rate table to calculate the tax liability (Reeves et al. 2-1). The transfer tax liability is imposed on the transferor or, in the case of estate tax liability, the transferor's estate.

Fair market value is the standard used to measure the value of property transferred and the amount subject to tax. Fair market value is defined by the Treasury Department's income tax regulations 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" (qtd. in United States IRS Revenue Ruling 59-60).

An inherent level of uncertainty exists in any fair market value estimate, because reaching an opinion of value is not an exact science. Rather, empirical data is supplemented with common sense, informed judgment and reasonableness (Mercer 6). Revenue ruling 59-60, which sets forth guidance to appraisers in reaching a fair market value estimate, warns appraisers to avoid the use of formula approaches and instead to weigh the relative facts and circumstances in each

situation (RR. 59-60 3.01). Therefore, obtaining a written valuation report from a qualified professional firm is a critical step in providing a taxpayer with confidence that a value estimate will withstand IRS challenge.

The degree of control an equity interest asserts over a business affects the fair market valuation of the property interest. The lack of control inherent in a minority interest results in one form of valuation discount. For example, the daily exchanges of millions of shares of publicly traded stock on the well-known exchanges take place at a minority interest level of valuation. An investor wishing to acquire a controlling interest in any of these entities must generally pay a premium over the minority per share price. Hence, there is often a surge in the market value of the publicly traded stock of companies who are the targets of acquirers.

Prior to Revenue Ruling 93-12, the IRS refused to recognize the validity of minority interest discounts in situations where control of an entity remained within a family subsequent to a gift of stock. After numerous losses in Tax Court, the IRS issued Revenue Ruling 93-12, in which they conceded some validity to minority discounts in intrafamily transfers. The result has been an increase in taxpayers' interest in lifetime gifting strategies as a way to minimize transfer tax liability.

The tax rate on cumulative lifetime and testamentary taxable transfers starts at 18% and reaches a marginal rate of 55% for taxable transfers in excess of $3 million (Reeves et al. Appendix 2A). These brackets are not indexed for inflation, thereby magnifying their impact. There is a three year time frame for

the IRS to challenge the value of property adequately disclosed on a gift tax return (2-8). For estate tax purposes, the IRS cannot re-value prior gifts if the statute of limitations for the gift has elapsed and the gift was adequately disclosed (2-8).

The IRS recently revised Form 709, United States Gift Tax Return, to require taxpayers to indicate if valuation discounts were utilized in reporting property values (Gardner 1). Taxpayers are required to provide an explanation for the claimed discounts. It appears that this is part of the IRS's overall efforts to identify and challenge valuation discounts more closely in light of the Service's setback in Revenue Ruling 93-12.

The first $625,000 of wealth transferred during life or at death is exempt from transfer tax under a unified credit afforded each person (Lochray 255). This exemption amount is scheduled to increase to $1 million dollars by the year 2006 (Reeves et al. 2-13).

The tax code provides that transfers between spouses are not subject to transfer tax. This provision is referred to as the unlimited marital deduction. However, a common mistake made by many married couples is to draft wills that leave the surviving spouse all of the assets of the deceased. The result is that the unified credit available to the first spouse to die is wasted. Fundamental estate planning should encompass dividing asset ownership between spouses in such a manner that the full benefits of each spouse's unified credit are realized. This result is often accomplished through the use of trusts.

The tax law also exempts charitable transfers from gift and estate tax. This has led some experts to view the transfer tax as a voluntary tax on wealth

accumulation. Individuals have a choice of paying tax to the federal government, for use in accordance with the government's latest budget, or they can control how their wealth will be used through transfers to selected charitable organizations (Thinking Beyond).

The estate tax is levied on the transfer of property when a person dies. The tax is measured based on the fair market value at the date of death, or six months after the date of death, if the alternate valuation date is elected (Reeves et al. 2-17). The tax liability is due nine months after the date of death, payable with an estate tax return filed by the estate's executor. In certain circumstances, the estate tax can be paid over a period of up to 14 years, if the estate qualifies under Internal Revenue Code (IRC) Section 6166 (Reeves et al. 14-10). The computation of the estate tax begins with the measurement of a person's gross estate. The gross estate includes the value of all property a person owned an interest in at death, including shared interests in property such as tenancies in common and joint tenancies. A common misconception is that property transferred to a revocable (living) trust during life is not includable in the gross estate. Revocable trusts enable property to avoid the probate process; however, the property is includable in the decedent's gross estate.

The federal gift tax is a backup tax to the federal estate tax. Without the gift tax, a person could plan to transfer all of his or her property during life, thereby eliminating the estate tax burden on his or her wealth accumulation. In addition, assets could be shifted within a family for income tax planning purposes (Leimburg 513). A gift tax liability is imposed on the donor for the fair market

value of lifetime transfers. A gift is defined as property transferred for less than full and adequate consideration (Reeves, et al. 2-1). A person is allowed to transfer up to $10,000 a year, to any number of donees, free of gift tax (2-11). Thus, an excellent estate planning strategy, for those with significant accumulated wealth, is to begin, at an early age, making as many $10,000 annual gifts as can be warranted, given the number of heirs in the family. A large amount of wealth can be transferred over time this way free of transfer tax.

The generation skipping transfer tax (GST) also backs up the federal estate tax. Without the GST tax, a person could make lifetime gifts to second and third generation heirs, thus delaying further transfer taxation on this wealth indefinitely. The GST tax is imposed on direct transfers to beneficiaries more than one generation below the transferor (2-46). The GST tax is in addition to any gift or estate taxes owed. The first $1 million dollars of property transferred to a skipped generation by a transferor is excluded from GST tax (2-47).

Traditional Wealth Transfer Techniques

All wealth must be transferred, either at death or during life. Waiting until death limits the options available to minimize transfer tax and achieve non-tax objectives, such as the successful transition of a family business. Transfers during life yield a better result; however, many successful people resist this route, due to a desire to retain control of what they have accumulated. The following section reviews fundamental testamentary and inter-vivos wealth transfer strategies, and introduces the concept of transition planning.

The importance of transition planning cannot be underestimated in achieving successful wealth transfer. Richard B. Elrod, JD, in his publication entitled Transition Planning for a Family Business, defines transition planning as "planning for the events which will take place when a business owner withdraws from active participation in the business." (6). Understanding transition planning is to know that there is more to wealth transfer planning than minimizing transfer taxes. Thinking Beyond, a wealth-preservation newsletter, cites a study which concluded that 65% of wealthy families have lost the family wealth by the end of the second generation, and 90% have lost family wealth by the end of the third generation (Thinking Beyond 1). This is attributed, in part, to a lack of trust and communication between senior family members and their immediate offspring (2). For example, if the younger generation have not played a significant role in business and wealth decision-making during the life of their parents, they may be ill-equipped to further the success of the business, or grow other wealth, after their

parents' demise. In summary, wealth transfer planning encompasses providing for the continuation of activities which have produced family wealth or maximization of the value of a family business, minimizing transfer tax costs and creating family harmony.

The most common vehicles for transferring property at death are wills, living trusts, and joint property. Living trusts have become favored vehicles over wills because they enable assets to avoid the probate process. However, assets transferred to a living (revocable) trust do not avoid inclusion in an individual's gross estate for calculating transfer tax liability.

The senior family member who leaves everything to his or her surviving spouse at death has likely not optimized family wealth. As mentioned previously, a minimum amount of assets should not pass via the unlimited marital deduction to ensure that each spouse's unified credit is maximized. This is accomplished using a credit shelter trust, discussion of which is beyond the scope of this paper. Leaving everything to a surviving spouse merely shifts the transfer tax burden to the surviving spouse's estate. Transferring stock in a business to a spouse who is not active in the business creates transition and continuity problems. Under that scenario, the business will need significant management depth and trustworthy advisors to continue successfully.

One upside to transferring property at death is the "step-up" in tax basis which is afforded the surviving spouse. For example, marketable securities having a tax basis of $1 million dollars and a fair market value of $5 million dollars at the decedent's death receive a "step-up" in tax basis to $5 million.

Thus, capital gains tax on the subsequent sale of the securities is limited to appreciation in excess of $5 million. However, this favorable income tax treatment is offset by the transfer taxes which will be owed on the $5 million dollars of value included in the taxable estate. In addition, transfer tax rates are significantly higher than capital gains tax rates.

The following section reviews the situation of a family business owner who dies owning an interest in a family business. Unless the unlimited marital or charitable deduction is utilized, transfer tax will be owed on the value of the taxable estate. Whether the business owner is in a controlling or minority interest position will significantly impact the amount of transfer tax owed. Life insurance owned by the estate or the heirs on the life of the deceased could be used to fund a portion of the transfer tax liability. This could alleviate some of the liquidity problems the estate may encounter. In addition, the estate might qualify for certain favorable tax payment plans, including a IRC Section 6166 installment election, discussed earlier, or a Section 303 redemption. Qualifying for a Section 303 election enables cash to be extracted from a corporation with little or no income tax liability (Reeves, et. al 14-5). However, both of these elections require meeting strict qualifications tests. In addition, the deceased may have not dealt with the underlying family transition issues prior to his or her death.

Even if an individual had no intention of transferring a business interest, certain unanticipated events can quickly upset these plans. Disability, withdrawal, and an untimely death are all events that can force a lifetime transfer; therefore, a

contingency plan is critical to a business owner for such events. Buy-sell agreements are generally the vehicle used to adopt a contingency plan.

The odds of achieving successful transfer tax minimization and effective transition planning results are greatly enhanced if the overall strategy includes lifetime transfers. Capitalizing on valuation discounts, removing future appreciation from the taxable estate, and reducing the "tax inclusive" estate tax liability are all benefits of lifetime gifting. In addition, committing to lifetime transfer strategy compels the senior family member to address the transition issues associated with preparing for the day when he or she will no longer be active in a business or in overseeing family wealth decisions.

Establishing a lifetime strategy for a business owner begins with a decision whether to keep a business in the family or transfer it outside the family. If keeping the business in the family is not a fundamental objective of the senior family member, then the primary issues are minimizing income tax liability and receiving fair market or greater value for the business.

The starting point for planning to transfer a business outside the family is to identify the potential purchasers. An Employee Stock Ownership Plan (ESOP) is a popular option because it allows the owner of a business interest to defer the income tax liability associated with the appreciation in the value of the business. However, the sale to an ESOP will likely result in less proceeds to the seller than the sale to a more synergistic buyer, who would contemplate the investment value of the business. An additional value maximization strategy includes a public offering of some or all of the closely held stock.

For many years, irrevocable trusts were the primary vehicles to facilitate lifetime transfers with an objective of keeping the business in the family. Prior to the rise of the family partnership in 1993, irrevocable trusts were the most popular vehicle for making lifetime transfers of wealth, including business interests.

In a typical strategy, a irrevocable trust is funded with life insurance. Annual gifts of the policy premium are made by the grantor. At the grantor's death, the life insurance proceeds are not includable in the grantor's taxable estate and are used to pay the estate tax owed on the grantor's wealth. Such trusts are commonly referred to as ILIT's, or irrevocable life insurance trust. In effect, the grantor is electing to pay the transfer tax with discounted, life insurance dollars.

More sophisticated irrevocable trust strategies involve transferring the actual business interest to the irrevocable trust. A transfer to an irrevocable living trust will normally result in some form of gift tax liability. Grantor retained annuity trusts (GRAT's), grantor retained unity trusts (GRUT's), and charitable lead and remainder trusts are all forms of irrevocable living trusts. In addition, there are dynasty trusts, which are irrevocable trusts whose terms generally extend as long as legally possible, to preserve wealth for future generations without the imposition of transfer taxes.

Intrafamily installment sales are an attractive option when the senior family member wishes to retain a cash flow stream from the property and the children or grandchildren are not in a position to make an outright purchase. In an intrafamily installment sale, the seller takes back a note receivable for the business interest or other property. Because the parties are related, there is

flexibility in dealing with such matters as the amount of the downpayment and terms of the installment obligation (Reeves 11-6). However, a taxable gift will have been made if the sale price of the property is less than fair market value (11-13).

There are income and estate tax benefits of installment sale transactions. Installment sales spread the capital gains tax recognition to the seller over the life of the note. In addition, the future appreciation of the property sold is removed from the seller's estate. The estate also achieves additional liquidity, as an illiquid closely held stock or real estate interest is replaced with proceeds under the installment note. Downsides include the loss of step-up in basis of the property at death, the inclusion of the fair market value of the note receivable in the taxable estate, and continuing income tax liability on the collection of installment note payments.

Two variations of intrafamily installment sales are self-canceling installment obligations (SCIN's) and private annuities. Both are useful in accomplishing wealth transfer planning where the objective is to keep the business in the family.

With a SCIN, the corporation redeems the stock of the seller, with the seller taking back a note receivable which is canceled at his or her death. Because the note is canceled, it is not included in the seller's gross estate. As with installment sales, there are adequate consideration rules, which require the redemption to take place at fair market value. In addition, the adequate consideration must be increased to reflect a risk premium to the seller, such as

compensation for the risk associated with dying before the note is paid in full (Reeves 11-15). In summary, a SCIN is another tool for converting property that would have been subject to transfer tax at high rates to property that is now subject to income tax on the unrecognized gain at lower rates (11-16).

A private annuity is similar to an installment sale; however, the periodic payments are based on the life expectancy of the seller, or the seller and the seller's spouse. Both the appreciating asset (e.g., closely held stock or real estate) and the annuity are removed from the taxable estate, and the annuitant has a source of cash flow during life (Leimburg 167). A fair market valuation estimate of the transferred property is needed to support the annuity payment stream and to avoid gift tax liability (Reeves 11-22).

Outright gifting of property represents a more simplified way of achieving lifetime transfers as opposed to using trusts or outright sales. Outright gifting provides the advantages generally afforded lifetime transfers, including capitalizing on valuation discounts, the removal of future appreciation from the estate, and the opportunity to utilize annual gift tax exclusions among others.

The drawbacks to outright gifting involve both psychological and practical issues. Most senior family members do not want to give up control during life of the wealth that they have committed their life's work to achieve. In addition, there are concerns over damaging the motivation and incentive of the younger generation. Furthermore, there is a general reluctance on the part of most people to contemplate their own demise. However, the non-tax and tax benefits of

lifetime transfers are so great that eventually those of wealth choose to confront the issues.

From a practical standpoint, many assets do not lend themselves to facilitating transfers of fractional interests via outright gifting. For example, if a senior family member wants to transfer one-fourth of a commercial real estate building to each of his or her children, it is a very cumbersome process to make outright gifts of a portion of the building. The same is true of a portfolio of marketable securities. It is not practical to have numerous individuals named on the title and leads to confusion over management and other issues. The family partnership has become the vehicle of choice for facilitating lifetime transfers because it offers tax and non-tax benefits to the senior family member, including enabling the senior family member to remove property from the estate while retaining a significant degree of control. The remainder of this report will focus on family partnerships, including their evolution, their workings, valuation issues and the building controversy surrounding their role in changing the landscape of estate and transition planning.

Chapter II

LITERATURE REVIEW

Historical Evolution of the Family Partnership

Prior to 1993, family partnerships were primarily used as a technique to shift taxable income away from parents in high tax brackets to their children in lower tax brackets. However, the Tax Reform Act of 1986 established that most income earned by children under age 14 is taxed at the top rate of their parents, thus reducing the benefits of shifting income to young family members.

Family partnerships have achieved their recent popularity largely because of the transfer tax benefits they provide. Up until 1993, the IRS refused to recognize, in most situations, valuation discounts on intrafamily wealth transfers. Revenue Ruling 81-253 disallowed valuation discounts on intrafamily wealth transfers if control of the entity continued to reside in a family. This was known as the "family attribution" ruling. Consider a senior family member with a 100% controlling interest in an entity. Assume this person transfers a 20% block of stock to a family member. Should this block of stock be valued at 20% of the prorata control value of the entity or after considering discounts for lack of control and marketability? Stacy Eastland, a highly regarded estate planning attorney with the law firm of Baker & Botts, L.L.P., notes that

> Only that property which is "transferred", whether as a result of the taxpayer's death or by gift during their life, can be subject to taxation under the federal estate and gift tax system. The tax cannot be a 'wealth tax' on the value of an asset in the hands of the decedent or donor immediately before a transfer occurs; rather, it must be a tax only on the fair market value transferred to the recipient as determined by reference to the hypothetical willing buyer/willing seller test. (4)

Prior to 1993, the IRS would have argued that the identity of the donor could be considered in concluding that no lack of control or marketability discounts were warranted in valuing the minority block of stock. However, this interpretation fails because the fair market value standard, established by Revenue Ruling 59-60, implies a hypothetical buyer and seller. Value for transfer tax purposes is determined without regard to the identity of the transferor, and transferee and the tax is imposed only on that which is transferred.

The IRS found itself consistently losing in the U.S. Tax Court when challenged on this issue (Eastland 6). Therefore, in 1993, the IRS issued Revenue Ruling 93-12, in which it stated that "the shares of other family members will not be aggregated with the transferred shares to determine whether the transferred shares should be valued as part of a controlling interest" (Rev. Rul. 93-12). With Revenue Ruling 93-12, the IRS effectively recognized minority interest valuation discounts on interfamily wealth transfers.

Revenue Ruling 93-12 opened the door to transfer tax minimization strategies using lifetime intrafamily transfers. As mentioned earlier, outright gifting is frequently resisted by senior family members due to their concerns about giving up control of family wealth. Family partnerships offer clients a solution to this concern. Not only does a family partnership allow wealth to be transferred in a family using valuation discounts, but it also allows for control of that wealth to remain with the senior family member. This combination has led to a tremendous increase in the use of family partnerships as a fundamental estate planning tool. The potential impact of the family partnership on transfer tax revenue collections has also led to the IRS asking Congress to limit their use.

The Tax and Non-Tax Benefits of Family Partnerships

Family partnerships have at least one general partner, who manages all of the partnership affairs, and one or more limited partners (Hochberg 65). The parents typically take back virtually all of the general and limited partnership interests, initially, in exchange for their contribution of the underlying partnership assets. Subsequent to the funding of the partnership, gifts of limited partnership interests are made to the children or other family offspring. The gifts of the limited partnership interests are typically valued for transfer tax purposes at anywhere from 20% to 40% less than the partnership's pro-rata underlying asset value.

As an example, assume a family partnership is funded with real estate having an appraised value of $10 million dollars. What is the value of a 10% limited partnership interest? The answer depends, in part, on the rights and restrictions afforded limited partners under the partnership's operating agreement and state default laws. If the partnership agreement imposes significant control and marketability restrictions on limited partners, the 10% interest will be worth significantly less than the pro-rata control value of $1,000,000.

Why are limited partnership interests often worth less than the prorata control value of the partnership's underlying assets? The reasons are primarily the lack of control and marketability features of these securities. Lack of control refers to such things as the inability of a limited partner to liquidate partnership assets or influence the timing and amount of partnership distributions. Limited

partners typically have no guaranteed rights to partnership assets or income in the form of cash distributions. Therefore, the question becomes, what would a hypothetical buyer be willing to pay for such an interest? If there is no guarantee of cash distributions and no way to force the sale of the partnership's assets, the answer may be "very little."

Lack of marketability also decreases the value of limited partnership interests. With publicly traded securities, such as The Coca-Cola Company or McDonald's Corp., the ability to turn share-holdings into cash involves merely picking up a phone and calling a broker. However, with privately-held equity interests, there are no such readily available markets. There are active buyers for controlling interests, yet the market for privately-held minority interests is very limited. Furthermore, limited partners are often restricted from selling or transferring their holdings without the general partner's consent (Fortune 96). This lack of a right to liquidate a partnership interest means that it is worth significantly less than a comparable, marketable security.

Ideal candidates for setting up family partnerships include individuals owning assets such as rental or commercial real estate, privately held business interests, or publicly traded securities among others. Typically, candidates are in a tax position whereby their effective transfer tax rate exceeds their effective income tax rate. Therefore, it is beneficial to convert property that otherwise would have been subject to high transfer tax rates to property that has some additional exposure to income taxes, however, at rates lower than those applicable to gift and estate taxes.

Costs and administrative burdens are considerations in deciding whether to set up a family partnership. In an article entitled "The Triple Double of Estate Planning: The Family Limited Partnership," David R. Nave advises that a family partnership (hereinafter also referred to as an FLP) should not be utilized unless the assets to be contributed exceed $1.0 million (159). Initial set-up costs include (1) the drafting of the partnership agreement, (2) title change fees associated with transferring assets to the partnership, and (3) appraisals of both the underlying assets and the limited partnership interests to be gifted (159). On-going maintenance costs include (1) accounting for the income and loss of the partnership, (2) filing of annual partnership tax returns, and (3) appraisal updates associated with subsequent year gifts (159).

The decision to establish a family partnership begins with identifying the assets to contribute to the partnership. Internal Revenue Code section 7701 indicates that the assets contributed must be of a trade or business investment nature or other type of income producing venture. Family partnerships are frequently funded with real estate, closely held stock, and/or marketable securities. Family partnerships funded with assets such as vacation homes or other personal assets have been attacked by the IRS as lacking a business purpose (Daniels).

Ideal assets include those with significant appreciation potential or with the ability to achieve a high rate of return, as such features compound the transfer tax benefits to the donor.

When contributing 100% of the assets, the donors takes back all of the general and limited partnership interests. It is the general partner who typically yields control over the direction of the partnership's strategy, the timing of cash distributions of partnership income, and decisions such as whether to sell partnership assets or to terminate the partnership. The general partner also assumes personal liability for the debts of the partnership. For this reason, some attorneys advise that the donor form a corporate entity, such as an S corporation, to serve as the general partner, with the donor owning the stock of the S corporation.

The transfer of the underlying assets to the partnership involves an appraisal of such assets, re-titling of asset ownership in the name of the partnership, and the execution of the partnership agreement. There are generally no immediate federal income tax consequences to the donor upon transferring the assets to the partnership (Tucker and Mancini 184).

The partnership agreement is the governing instrument that spells out the rights and responsibilities of both the general and limited partners. Control and transferability restrictions in the partnership agreement with respect to limited partnership interests give rise to the valuation discounts that will allow for the transfer of limited partnership interests out of the donor's estate at less than prorata net asset value. The result is that the value of the assets transferred and all appreciation subsequent to the date of the gift will not be subject to estate tax at the death of the donor.

While the transfer tax benefits realized are significant, the ability of the senior family member to retain control of the partnership assets is what has established the family partnership as the premier estate planning tool of today. Historically many people of wealth procrastinate before entering into lifetime gifting programs. While they were aware of the transfer tax benefits of lifetime gifting, they refuse to give up control of the wealth they have worked a lifetime to achieve. With the current family partnership structure, lifetime transfers can be made without the donor having to forgo control of the underlying partnership assets. The general and limited partnership structure of the family partnership structure produces these results.

Protection from creditors is a third benefit of FLP's, in addition to the transfer tax and control retention aspects discussed above. If a limited partner has creditors, such creditors are severally restricted from being able to satisfy those debts by taking partnership assets (Adams 55). Therefore, a senior family member can make gifts of limited partnership interests to his or her offspring without fear that creditors of the child can attack the partnership assets. Such a creditor would typically be limited to gaining a "charging order" with respect to the limited partnership interest. A charging order only allows the creditor to receive those distributions to which the junior family member would have been entitled (55). Since the senior family member controls the timing and amount of the distributions, the creditor, who also becomes liable for the income taxes on the limited partner's share of the partnership income, may be left with an income tax liability and no cash distributions as a result of the charging order.

There are additional benefits of establishing a family partnership beyond transfer tax savings, control retention, and protection from creditors. These additional benefits include the following:

- ***Access to professional money managers***. In the case of a family partnership funded with cash and marketable securities, the pooling of family investment portfolios may allow access to professional money managers, such as those operating high initial contribution hedge funds, who would otherwise be inaccessible (Fortune 96).
- ***Simplified annual giving***. The fractional nature of a family partnership interest lends itself to making annual gifts in a manner that is easier than gifting a direct interest in an underlying asset (Harrison 71).
- ***Flexibility***. As goals and objectives change, a family partnership agreement can be amended to fit such needs. This is in contrast to vehicles such as irrevocable trusts, which are much less flexible to changing family needs.
- ***Income Shifting***. Limited partners are annually allocated their prorata portion of partnership income. In some cases, the result will be income that is taxed at the limited partner's lower tax rate as opposed to the general partner's higher tax rate (Marcus 69).

Fundamental Valuation Concepts

The valuation of a family partnership interest is based on the same theory and principles that are used in the appraisal of closely-held corporations. The appraisal of closely held corporations is based on general value theory, which has evolved greatly over the past 30 years. General value theory encompasses the principles, concepts of value, definitions, models, statements of methods, analyses, logic, and evidence needed to carry out appraisal practices. The following is a discussion of the more relevant aspects of general value theory as they relate to the appraisal of a closely held corporation. Understanding these concepts will enhance the understanding of family partnership appraisal practices, which are discussed later in this report.

An appraisal of a closely held corporation begins with the seemingly basic question of what is to be appraised. Is it the corporation's assets or its equity? If equity is to be appraised, is it on a controlling or minority interest basis? The answers to these questions are critical to establishing the appraisal methodology to be utilized and understanding the valuation conclusion reached. More specifically, establishing what is to be valued will alert the appraiser to the potential presence or absence of valuation premiums and discounts.

A second fundamental item to establish is the date of the appraisal. Valuation is date specific, changing at different points in time as the outlook for the future growth of the company enhances or deflates.

The next item to clarify is the purpose of the appraisal. It is the purpose of the appraisal that will establish the applicable standard of value to be used. In appraisals for gift and estate tax purposes, the IRS has stated that fair market value is the applicable standard of value. Fair market value implies a hypothetical arm's length transaction without regard to a specific buyer or seller (Fishman et al. 2-2). This contrasts with the investment value standard, which implies the value of an asset or business to a specific individual (2-2). Therefore, the investment value standard is more applicable for purposes such as acquisitions and divestitures, where specific buyer synergies, knowledge and abilities are taken into account.

Another important consideration is identifying what "level of value" attributes a particular equity interest possesses. The phrase "level of value" relates to the degree of control and marketability a particular equity interest possesses. The three primary levels of value are

- Control Value
- Marketable, Minority Value
- Non-Marketable Minority Value

Control value refers to a block of stock possessing operating or absolute control of an entity. The ability to elect a majority of the board of directors is reflective of operating control (Fishman et al. 2-4). Absolute control refers to an ownership interest that can exercise all of the prerogatives of control in an entity

(2-4). In his book entitled Guide to Business Valuation, Jay Fishman identifies such corporate prerogatives of control, including among others the right to

- Set the strategic course of the business
- Appoint management and determine compensation
- Sell or liquidate the company
- Declare and pay dividends

Controlling interest value can be best understood by understanding the definition of minority interest value. Fishman defines a minority interest as "all interests that have less than 50% of the voting interest in a company" (2-4). In essence, there are two values attributable to the aggregate equity of a business: (1) the aggregate equity on a controlling interest basis and (2) the aggregate equity on a minority interest basis. The aggregate equity on a minority interest basis reflects discounts, relative to the aggregate control value of the equity, reflective of the lack of prerogatives of control and diminished marketability.

The millions of shares which change hands on a daily basis on publicly traded stock exchanges, such as the New York Stock Exchange, reflect marketable, minority interest transactions. They represent the value of a business from the perspective of individuals who do not have the ability to influence the future course of the company. An acquirer of such influence typically pays a premium over and above the minority share price for such rights. These premiums, often ranging from 20% to 40%, are seen when an acquisition is announced and shares of the targeted company adjust upward to a control level of

value. Mergerstat Review publishes an annual study which tabulates control premiums paid in change of control transactions involving publicly traded companies. From 1987 to 1996, the weighted average control premium paid for all industries was 31% (Mergerstat Review 23). The implied ten-year weighted average minority discount was 23.7%.

The third level of value is the non-marketable, minority interest level. While shares of most publicly traded minority interests can be rapidly converted to cash by calling a broker, a minority interest holding in a closely held corporation is not nearly as marketable. There is no active market for minority interests in closely held businesses. If the likelihood of a company making a public offering or being acquired is slim, then the lack of marketability of the interest is even more pronounced.

Multiple studies have been undertaken over the past 30 years which have resulted in a body of empirical data with regard to marketability discounts adhering to closely held stock. These studies are classified into two groups: (1) restricted stock studies and (2) pre-IPO transaction studies. In the restricted stock studies, analysts compared transaction prices in "lettered" stock to the stock's freely traded counterpart. Letter stock is stock of a publicly traded company which is restricted from trading on a public exchange for a certain period of time (Fishman et al. 8-28). The only difference between a company's letter stock and its publicly traded stock is its marketability, therefore isolating the liquidity variable.

The following summary of restricted stock studies was published in Shannon Pratt's Valuing a Business, 3rd ed. The studies provide strong empirical

evidence for average marketability discounts relating to minority interests of approximately 35%. However, the marketability of each subject interest appraised must be assessed on a facts and circumstances basis.

Table One

Summary of Restricted Stock Studies

Study	Years Covered in Study	Average Discount
SEC, Overall Average[a]	1966 to 1969	25.8%
SEC, Nonreporting OTC Companies[a]	1966 to 1969	32.6%
Gelman[b]	1968 to 1970	33.0%
Trout[c]	1968 to 1972	33.5%
Moroney[d]	j	35.6%
Maher[e]	1969 to 1973	35.4%
Standard Research Consultants[f]	1978 to 1982	45.0%
Willamette Mgmt. Assoc., Inc.[g]	1981 to 1984	31.2%
Silber[h]	1981 to 1988	33.8%
FMV Opinions, Inc.[i]	1979 to 1992	23.0%
Management Planning[l]	1980 to 1995	27.7%

Notes

a. From "Discounts Involved in Purchases of Common Stock (1966-1969)," Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 64, Part 5, 92d Cong., 1st Sess. 1971, pp. 2444 -2456.

b. From Milton Gelman, "An Economist? Financial Analyst's Approach to Valuing Stock of a Closely Held Company," Journal of Taxation, June 1972, pp. 353-354.

c. From Robert R. Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities," Taxes, June 1977, pp. 381-385.

d. From Robert E. Moroney, "Most Courts Overvalue Closely Held Stocks," Taxes, March 1973, pp. 144 - 154.

e. From J. Michael Maher, "Discounts for Lack of Marketability for Closely Held Business Interests," Taxes, September 1976, pp. 562-571.

f. From "Revenue Ruling 77-287 Revisited," SRC Quarterly Reports, Spring 1983, pp. 1-3.

g. From Willamette Management Associates Study (unpublished).

h. From William L. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," Financial Analysts Journal, July-August 1991, pp. 60-64.

i. From Lance S. Hall and Timothy c. Polacek, "Strategies for Obtaining the Largest Valuation Discounts," Estate Planning, January/February 1994, pp. 38-44.

j. Although this study likely analyzed 1969 through 1972, no specific years were given in the published account.

k. Median discounts.

l. Published in Business Valuation Update, October 1997, Vol. 3 No. 10

Source: Pratt, Shannon P., Robert F. Reilly, and Robert P. Schweihs, "Valuing a Business: The Analysis and Appraisal of Closely Held Companies" Irwin Professional Publishing, 1996)

The second set of marketability research is referred to as the pre-IPO studies. Appraisers had speculated that if marketability discounts exist for letter stock, which represents stock that will eventually have access to the publicly traded markets, the marketability discount attributable to stock without a freely traded counterpart may be even greater. The pre-IPO studies gathered empirical data in an attempt to shed light on this premise.

When a company registers to go public, it has to disclose all transactions in its stock going back three years. Two ongoing pre-IPO studies, one by Willamette Management and the other by Robert W. Baird & Co. ("Baird"), have utilized this data to compare pre-IPO transaction prices to subsequent public offering prices. Eight Baird studies, from 1980 to 1997, encompassed 310 transactions, with a median discount of 43%. The results of the Baird studies appear to indicate greater marketability discounts adhering to companies for whom the public markets are a more speculative proposition. However, this is a controversial area in the appraisal profession, with some appraisers believing that the higher discounts are attributable to factors such as hyped IPO pricing (Lerch).

In summary, closely held minority interests suffer from both lack of control and lack of marketability attributes. It is these features that make minority interest transactions such an effective part of estate planning. The valuation discounts adhering to minority interests can serve to reduce transfer tax values and related taxation.

The Three Approaches to Value

Traditionally the development of a market value opinion is based on the utilization of three basic approaches to value: the market, income, and cost approaches. These three approaches developed largely out of early appraisal theory, with Henry Babcock's work Appraisal Principles and Procedures playing a large role. Under this original theory, asset valuation methodology was classified into these three basic approaches. While Babcock's book is still considered an authoritative text with respect to appraisal practice, the growing area of business valuation methodology has proven more difficult to categorize. Many business valuation methods actually combine two or more approaches to value (Fishman et al. 2-5).

A brief description of the three approaches follows, along with their limitations.

The Market Approach to Value

The market approach involves comparing the subject business to similar businesses which have been sold. The concept assumes that value can be estimated from analyzing recent sales of comparable assets. The use of this approach involves an in-depth search for guideline companies and thorough analysis and adjustment of the comparative data.

The IRS has given indication through revenue rulings and case precedent of favoring the market approach over other approaches, if the use of the approach is feasible. The IRS's line of reasoning is that values are best tested and

determined in the marketplace; thus, this is the most reliable data on which to base a valuation. However, the lack of quality guideline company data can be a limiting factor in applying this approach.

The comparability of publicly traded guideline companies used in a valuation frequently becomes a central issue in litigated appraisals, partly because of the difficulty of choosing truly comparable companies. In <u>Tallichet v. Commissioner</u>, the Tax Court emphasized that there are "guideposts to comparability" (Tallichet v. Commissioner, (33 T.C.M. 1133 (1974))). The Court indicated the following factors which must be considered in determining comparability:

- Capital Structure
- Credit Status
- Depth of Management
- Personnel Experience
- Nature of Competition
- Maturity of Business

An additional position which was strongly emphasized in the <u>Tallichet v. Commissioner</u> case was that if there are no companies sufficiently comparable to the business being appraised, then the appraiser should look to other valuation methods.

The Income Approach to Value

The statement "the value of a business is equal to the present worth of the future benefits of ownership" provides the concept underlying the income approach to valuation. The term "income" does not refer to income in an accounting sense, but rather in terms of future benefits accruing to the owner. Using the income approach, the appraiser estimates the future ownership benefits and discounts those benefits to their present value using a rate suitable for the risks associated with achieving those benefits.

The income approach is limited primarily by the difficulty of forecasting future earnings. The appraiser must consider historical trends, management's outlook, the company's track record relative to achieving projected results, industry conditions, and the outlook for the economy in general in relying on the income approach.

The Cost Approach to Value

The cost approach represents a general way of determining a value indication, utilizing one or more methods based on the value of the assets of the business less liabilities (American Society of Appraisers, "Business Valuation Standards: Definitions").

The cost approach has several limitations in valuing a business which is a going concern. Often the value of the underlying assets represents only a floor of value. As an indicator of the total fair market value of an entity, book value has the disadvantage of considering the status of the business only at one point in time. Adjusted book value does not take into account the earnings capacity of the

business into the future. Some have likened book value as closer to unadjusted liquidation value than to an indicator of fair market value.

Revenue Ruling 59-60

Even though it was written nearly 40 years ago, Revenue Ruling 59-60 is still considered one of the best sources of guidance for the appraisal of closely held stock. The Revenue Ruling was originally written for the purpose of outlining those factors which should be considered in the valuation of closely held stock for estate and gift tax purposes (Bar Association of Metropolitan St. Louis 3). The Department of Labor has indicated that this Revenue Ruling should be followed for ESOP purposes, also.

One of the reasons that Revenue Ruling 59-60 has become so widely accepted within the appraisal profession is that it addresses those operational characteristics that are indicative of the value of a business. Significant messages imparted to appraisers within the ruling include the following:

- Valuation of securities is essentially a prophecy of the future and must be based on facts available at the required date of appraisal.
- Generally the prices of stocks which are traded in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporation and the industries presented.
- When a stock is closely held, traded infrequently, or traded in an erratic market, some other measure of value must be found. In many instances, the next best measure may be found in the prices at which stocks of companies

engaged in the same or similar line of business are selling in a free and open market.

Section 4 of the ruling addresses factors that the appraiser should consider in performing the appraisal. The ruling states that it is advisable to emphasize in the valuation of the stock of closely held corporations, all available financial data, as well as relevant factors affecting fair market value, should be considered (RR 59-60). The ruling then goes on to describe eight fundamental factors which require careful analysis:

- The economic outlook in general and the conditions 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 company
- The dividend-paying capacity
- Whether or not the enterprise had goodwill or other intangible value
- Prior sales of the stock and the size of the block of stock to be valued
- The market price of stocks and the sizes of corporations engaged in the same or a similar line of business having their stocks actively traded on an exchange or over-the-counter market

In summary, Revenue Ruling 59-60 imparts the message that the valuation of closely held stock depends on consideration of the facts and circumstances surrounding each entity appraised, and it is not formula-orientated.

Introduction to Family Partnership Valuation

Family partnerships invoke the concept that the value of an asset is influenced by the form in which that asset is owned. For example, if you could purchase a fractional interest in real estate directly, or you were forced to purchase it through another entity (e.g., a partnership), would you pay the same amount for each asset? In a presentation at the 1996 AICPA National Business Valuation Conference, Robert E. Duffy, a principal with the valuation firm Brueggman and Johnson, argued that an asset with another security wrapped around it is worth less than direct ownership. Bruegmann pointed out that the "entity envelope" creates a barrier between the minority investor and the underlying partnership assets. Typically the minority investor cannot liquidate or force the sale of these assets. In addition, the investor is often restricted from transferring his ownership interest. Furthermore, there usually is a layer of expenses at the entity level (e.g., management and administration fees) which reduces the net income of the partnership relative to the total revenue produced by the asset.

Such realities give rise to discounts for lack of control and marketability, which result in an interest being worth less than the pro-rata value of the underlying net assets. These discounts are also referred to as "adjustments to net asset value" (Duffy). Thus, the ability to transfer wealth at an amount less than the unadjusted net value of the underlying assets, coupled with the resulting transfer tax savings, has spurred great interest in family partnerships.

It has also caused the IRS to take a close interest in family partnerships and attack those transfer transactions which show the greatest likelihood of yielding additional tax for the Treasury. Therefore, it is critical that the client and attorney retain a qualified business appraisal firm at the outset of establishing the estate plan.

Owen G. Fiore, Esq., a nationally recognized estate planning attorney, notes that one of the most important reasons to add a business appraiser to the estate planning team, early in the process, is because an appraiser provides "credible evidence of value as an expert" (Higgens 74). Fiore also notes that clients who can show "good faith reasonable reliance" on the work of an appraiser in valuing a business interest may avoid subsequent valuation understatement penalties which otherwise would have been imposed (74).

The following chapter of this report provides an in-depth discussion of family partnership valuation methodology.

Chapter III

FAMILY PARTNERSHIP VALUATION METHODOLOGY

The Fundamentals of Appraising Family Partnerships

The appraisal process in the valuation of a family partnership interest can be broken down into the following steps:

- Establish the engagement fundamentals
- Obtain appraisals of the underlying partnership assets
- Gain an understanding of the partnership agreement
- Develop the valuation adjustments applicable to the interest being appraised
- Produce a narrative report

The following is an overview of each of these areas of the appraisal process.

Establish the Engagement Fundamentals

The process of planning a family partnership appraisal is very similar to that of an engagement to appraise an interest in a closely held operating entity. The appraiser must identify exactly what is to be appraised. Is it a non-marketable minority interest in a partnership? Or a controlling interest? The answer to these questions will impact the magnitude of subsequent valuation discounts. The analyst must also establish the purpose of the appraisal and who the client is (typically the client is the estate planning attorney, a general partner or a limited partner). In addition, the valuation date must be established.

Furthermore, the appraiser needs to understand exactly which entity he or she is being asked to appraise. Advanced estate planning often involves the use of multiple entities which can add layers of complexity to these seemingly basic tasks.

Obtain Appraisals of the Underlying Partnership Assets

The starting point in developing an opinion of the value of a family partnership interest is a determination of the partnership's unadjusted net asset value (Schroeder). A partnership's unadjusted net asset value is equal to the partnership's assets at fair market value less any liabilities of the partnership. If a partnership includes real estate, a real property appraiser is typically engaged to appraise the fair market value of the properties at a date near that of the planned transaction. A well-documented appraisal of the underlying assets of the partnership is an important starting point in minimizing transfer taxes using a family partnership. If the underlying assets are marketable securities, then asset appraisals are typically available from monthly brokerage statements. A family partnership funded with closely held stock necessitates an appraisal of the family business as well as the family partnership. Frequently family partnerships are funded with interests in other privately-owned partnerships, the value of which must be ascertained as the starting point of the engagement.

It is the appraiser's responsibility to ensure that complete inquiries are made to ensure that all of the partnership's assets and liabilities have been identified and considered.

Gain an Understanding of the Partnership or Operating Agreement

It is important that the appraiser gain an understanding of the partnership or other operating agreement governing the family entity. Such agreements set forth the rights and restrictions afforded holders of general and limited partnership interests. Understanding these rights and restrictions will enable the appraiser to determine the magnitude of net asset value adjustments necessary to arrive at the fair market value of a partnership interest.

An appraiser should understand what rights limited partners have concerning the amount and timing of cash distributions. A hypothetical buyer would likely pay less than net asset value if distributions are discretionary on the part of the general partner as opposed to a partnership which calls for a minimum distribution requirement (Fishman et al. 14-8). Empirical data indicates that cash distributions are the most significant factor in the market pricing of publicly registered limited partnerships (14-8).

Limited partner withdrawal rights also play a key role in measuring net asset value adjustments. If either the partnership agreement or state law allow limited partners to have their interest redeemed for fair market value upon reasonable notice, then net asset value reductions for lack of control will be minimized (14-8).

The ability of a limited partner to compel a partnership dissolution or liquidation also has a debilitating effect on valuation discounts from net asset value. Such rights enable a limited partner to have the opportunity to realize proceeds from the underlying partnership assets quicker, thereby giving credence

to a liquidation value premise as opposed to a going concern premise. In the case of the valuation of a limited partnership interest, a liquidation premise (which is asset based) will likely result in a higher value estimate than a going concern premise (which is cash flow based).

Restrictions on the ability of a limited partner to transfer an ownership interest are frequently found in family partnerships because they foster a common goal of senior family members of keeping assets in the family. Such restrictions also serve to promote net asset valuation adjustments which reduce value for transfer tax purposes. For example, the partnership agreement may give the general partner a right of first refusal with respect to a proposed transfer of a limited partnership interest. Furthermore, the agreement may call for general partner approval to be obtained for all proposed limited partnership interest transfers. If the general partner does not approve, the recipient of the partnership interest may be afforded only assignee status, as opposed to being granted full rights afforded a limited partner. As an assignee, the individual would have even fewer rights than a limited partner, thereby reducing the amount he or she would be willing to pay for the interest. Thus, the transferability restrictions serve to increase the magnitude of the net asset value adjustment attributable to lack of liquidity.

The following table, compiled by Jay Fishman in his Guide to Business Valuations (1997 edition), summarizes the impact on value of common partnership agreement clauses:

Table Two

Summary of the Effect of Articles of Partnership on the Value of a Limited Partnership Interest

Partnership Article	Options	Effect on Valuation
Term or life of entity	Indefinite life	Decreases value
	Limited life	Increases value
Ownership and Capitalization	Cash call provisions	Decreases value
	No cash call provisions	Increases value
Nature of management rights	Few management rights	Decreases value
	Active management rights	Increases value
Extent of voting and other rights	Few voting or other rights	Decreases value
	Equal voting rights	Increases value
Restrictions on unit transfers	Rigid restrictions	Decreases value
	No restrictions	Increases value
Allocation of income and loss	Equal allocation	No effect on value
	Income allocated less to limited partners	Decrease value
	Losses allocated more to limited partners	Decrease value
Cash distribution requirements	No minimum distribution requirements	Decrease value
	Minimum distribution requirements	Increase value
Withdrawal rights	Easy to withdraw	Increase value
	Difficult to withdraw	Decrease value

Source: Fishman, Jay E., et al. Guide to Business Valuations. Fort Worth: Practitioners Publishing Company, March 1994.

Development of the Adjustments Specific to the Appraised Interest

At this stage, the appraiser has determined the unadjusted net asset value of the partnership and has gained an initial understanding of the partnership agreement and operating history of the entity. Therefore, the appraiser is now ready to assess the magnitude of discounts applicable to the net asset value of the partnership. Conceptually the partnership's net asset value represents the control value of the partnership equity. For purposes of providing an opinion of value of a limited partnership interest, the control value of the equity must be converted to a non-marketable minority level of value. As discussed earlier in this report, this conversion process requires adjustments for the lack of control and lack of marketability inherent in a specific limited partnership interest.

The concept of a family partnership entity is similar to that of an investment company. Investment companies typically serve as holding company vehicles for certain underlying assets; therefore, they derive most of their value from the value of those assets. This asset-intensive nature of investment companies and family partnerships typically results in the cost approach being the most relevant valuation approach to use in valuing a family partnership. IRS Revenue Ruling 59-60 indicates that the value of an investment company is closely related to the value of its underlying assets; therefore, the adjusted book value method, a method of applying the cost approach, is the most relevant method of valuing a closely held investment company.

The development of lack of control and lack of marketability adjustments applicable to a partnership's net asset value is a processes of identifying and assessing relevant empirical market data and relating it to the facts and circumstances of the subject interest. This process of considering the unique aspects of the subject interest such as the nature of the underlying assets, the rights and restrictions imposed by the partnership agreement, and the operating history of the entity is crucial to obtaining a supportable appraisal, tasks best completed by a qualified professional appraisal firm with staff specializing in the valuation of financial securities. While a qualified business valuation is no guarantee that the IRS will not challenge the resulting value, if the appraiser has been objective and unbiased and has provided a well-documented and supportable result, the donor will be on much better footing than a donor who has not engaged such professional expertise.

Identifying relevant empirical market data serves to establish what discounts from net asset value investors are placing on securities similar to the subject family partnership interest. The starting point is to identify market data resulting from investment companies which most closely reflect the operations of the family partnership. Family partnerships are typically funded with closely held stock, real estate, or marketable securities. The following is a discussion of the various empirical market data available from investment companies owning similar types of underlying assets.

Limited partnership interests in family partnerships whose underlying assets consist of closely held stock warrant a discount from net asset value for

lack of control on the same conceptual grounds that gives rise to closed-end fund discounts from net asset value.

The publicly traded per share market prices of closed-end funds are published weekly in Barron's National Business and Financial Weekly. Barrons also publishes the net asset value of the fund, making market price-to-net asset value premium and discount data readily available. A closed-end fund is a type of fund that has a fixed number of shares and is usually listed on a major stock exchange. These funds are different from mutual funds in that the fund does not stand ready to issue and redeem shares on a continuous basis. Furthermore, there is no requirement, unlike mutual funds, that an investor's shares be redeemed at net asset value. The underlying assets of closed-end funds are typically portfolios of stocks, bonds, and/or specialized equity securities.

In December 1997, the median discount from net asset value of 43 closed-end funds tracked by Barrons was 10.2%. This median discount can be attributed to (1) the "entity wrapper" surrounding the assets, and the associated fees and expenses which reduce the ultimate return to shareholders, (2) the inability of minority investors to influence the fund managers' strategy and capital allocation decisions, and (3) the entity barrier which limits an investor's ability to realize the full proceeds of the underlying assets.

Family partnerships are also frequently funded with commercial real estate. To measure discounts from net asset value for family limited partnership interests funded with real property, appraisers look to secondary market transactions involving publicly registered limited partnerships. Data on these

transactions is compiled by Partnership Profiles, Inc. and published in their bimonthly service called The Partnership Spectrum. The data provided includes the weighted average-per-share market price of certain partnership transactions along with information on the partnership's net asset value per share, thus making the resulting premium or discount readily visible.

According to Spencer Jeffries, publisher of The Partnership Spectrum, the biggest factors influencing the price buyers in secondary markets are willing to pay for limited partnership interests are (1) whether the partnership is consistently paying periodic cash distributions and (2) the degree of debt financing utilized by the partnership (qtd. in Business Valuation Update, September 1997 ed.).

The following table summarizes the results of data compiled by The Partnership Spectrum involving 928 limited partnership transactions in 130 real estate partnerships occurring during April 1, 1997 to May 30, 1997:

Table Three

Discounts from Net Asset Value for Non-Distributing and Distributing Partnerships

Partnership **Category**	# of **Partnerships**	Average **Discount**	Average **Yield**
Equity – Non-Distributing	27	42%	0.0%
Equity – Distributing (moderate to high debt)	24	37%	7.2%
Equity – Distributing (low or no debt)	48	28%	8.1%

Source – Business Valuation Update – Vol. 3, No. 9, September 1997

The table above indicates that the largest discounts from net asset value occurred in non-distributing partnerships. The discount from net asset value averaged 42% in these 27 partnerships. Furthermore, 8 of these 27 partnerships had comments indicating near term prospects for cash distributions. When these 8 were eliminated, the average discount for the remaining group of 19 rose to 46% (Business Valuation Update, September 1997 ed.).

The discounts referred to above are primarily based on the lack of control aspects of the limited partnership interests. A limited partner typically cannot influence the timing and amount of cash distributions nor influence the strategic direction of the partnership. However, there is some lack of marketability aspect in the above discounts, as the partnership secondary market offers nowhere near the liquidity of stock exchanges such as the NYSE or NASDAQ.

There are varying views as to the degree that the lack of marketability discount is present in the real estate limited partnership (RELP) data. Shannon Pratt, a highly respected leader in the financial appraisal industry, noted in the September 1997 edition of Business Valuation Update, that increases in trading volume in the secondary markets have had the effect of diminishing the lack of marketability aspect of discounts in RELP transactions. However, subsequent to Pratt's comments, secondary market trading volume has seen significant decreases, primarily due to the forced liquidation of the Chicago Partnership Board in late 1997 (Business Valuation Update, April 1998 ed.). The Chicago Partnership Board was one of several firms providing underwriting and market-making services in the limited partnership industry. Overall, there does appear to be an element of illiquidity discount imbedded in the RELP transaction data, particularly after considering that the majority of the secondary market volume is concentrated in the hands of a relatively few partnerships. It is not clear how much of the discount, however, is attributable to illiquidity.

Limited partnership interests in family partnerships funded with marketable securities (e.g., publicly traded stocks and bonds) warrant a discount from net asset value because the partnership "entity wrapper" typically prohibits the investor from reaching the underlying assets. If the investor cannot force the liquidation and distribution of the assets nor sell their interest, then discounts from net asset value are warranted.

The IRS has expressed increasing levels of frustration with the erosion of the transfer tax base which has resulted from the successful use of family

partnerships to transfer wealth at reduced values. The Service, seemingly recognizing the conceptual validity of discounts attributable to limited partnership interests, has largely chosen to wage its battle on more promising fronts. These include (1) attacking the "deathbed" creation of FLP's, (2) attacking FLP's with no underlying business purpose other than tax avoidance, and (3) pushing for legislation that would eliminate discounts for those family partnerships where the property is a non-operating business, including those funded solely with marketable securities.

The empirical data supporting net asset value adjustments attributable to limited partnership interests in family partnerships funded with marketable securities is the same as that used in analyzing FLP's funded with closely held stock, that is, closed-end fund market transaction data relative to the net asset value of the fund. The closed-end fund data supports discounts for lack of control of approximately 10% to 15% as of this writing, prior to consideration of the facts and circumstances applicable to the subject interest being appraised.

Development of the Discount for Lack of Marketability

The source of the empirical data used to develop the lack of control discount serves as the starting point in assessing the appropriate discount for lack of marketability. As discussed earlier, these two discounts have been recognized as separate and distinct discounts by previous U.S. Tax Court precedent. As discussed above, the reliance on closed-end fund data in assessing lack of control adjustments in family partnerships funded with closely held and publicly traded securities represents transaction data from major exchanges. Clearly they represent marketable interests, whereas the subject family partnership interest is typically non-marketable. Therefore, a further discount for lack of marketability is likely warranted.

As discussed earlier, the secondary market for limited partnerships is not as liquid a market as the major exchanges; therefore, the discounts from net asset value evidenced in these RELP transactions reflect some component of illiquidity. Certainly, the appraiser should consider this fact in assessing a further lack of liquidity adjustment when working with RELP data.

Relying on the sources of empirical data discussed above, in developing a lack of control discount, establishes that some further discount for lack of marketability is warranted in estimating the value of the subject limited partnership interest. The most important factors driving this discount are the restrictions on the limited partner's ability to liquidate the partnership or sell his or her partnership interest. An ability to liquidate the partnership, or if liquidation

of the partnership is imminent, will result in the minority interest realizing the control value of the partnership's equity, as represent by the partnership's net asset value, thereby eliminating any discounts. Furthermore, if an interest is freely transferable, that fact increases the likelihood of liquidity, thus mitigating the lack of marketability discount.

Assessing the appropriate lack of marketability discount applicable to a family limited partnership interest requires the qualities of reasonableness and seasoned judgment on the part of the appraiser. Appraisers typically use the "standard" lack of marketability studies discussed earlier in this report to establish a framework for assessing the magnitude of the discount. These studies include the restricted stock studies and the pre-IPO studies, both of which support lack of marketability discounts of at least 35% for stock of closely held operating entities.

Appraisers acknowledge that these studies provide results which are not directly comparable to valuing family limited partnership interests; however, they are widely seen as being the best starting point available.

The restricted stock and pre-IPO studies measure the detrimental effects of the lack of liquidity on operating entity interests. One could argue that liquidity is a more important aspect of owning an interest in a closely held operating entity as opposed to an asset-intensive investment company because closely held operating entities derive their value from their ever-changing growth prospects. Investment companies derive their value from the return generated by their underlying assets, the fortunes of which may not be as volatile in some cases as a closely held operating entity. Therefore, the ability to "get out" of an investment when there is

operating entity. Therefore, the ability to "get out" of an investment when there is a perceived downturn may be a more important value attribute of a closely held operating entity than an investment company funded with, for example, large capitalization securities. Of course, in volatile securities markets, the ability to "get out" of a privately-held partnership investment where the underlying assets are investment securities is an important attribute.

The above discussion is not meant to imply that a separate lack of marketability adjustment is not warranted in appraising FLP interests; rather an appraiser needs to consider mitigating the "standard" lack of marketability empirical data as part of the correlation process.

An appraiser goes through a process of synthesizing (1) the source of empirical data used in developing the lack of control adjustment, (2) the specific illiquidity features of the subject interest, and (3) consideration of the restricted stock and pre-IPO studies to arrive at an appropriate discount for lack of marketability.

Application of Empirical Data to the Subject Company Interest

Once the empirical market data has been gathered and assessed, the appraiser is now ready to compare the lack of control and marketability characteristics of the subject interest with the empirical data in order to quantify the applicable discounts.

The mixture of the underlying assets in the family partnership should be considered. If there are multiple classes of assets, e.g., real estate and marketable securities, consideration should be given to weighting the lack of control adjustment based on the weighting of the asset classes in the partnership.

In assessing the lack of control discount, consideration should be given the subject partnership's history of distributions, along with the prospects for starting or increasing distributions. If there is a history of distributions, this may serve to mitigate some of the restrictive aspects of the partnership agreement regarding limited partner rights to cash distributions.

Some of the other features of the subject partnership which should be assessed include (1) evidence of lack of voting control, (2) income and loss allocation provisions, (3) duration of the partnership, (4) size of the interest, and (5) ability or inability to remove general partners.

The primary lack of marketability features to assess include (1) ability, likelihood or prospects for liquidation, (2) extent of restrictions on transfer, and (3) prior sales of partnership interests.

In addition, in a fairly recent landmark Tax Court case, Mandelbaum v. Comm. (T.C. Memo 1995-255), Judge David Laro cited nine factors which should be considered in determining a discount for lack of marketability. Although this case involved a closely held business interest, these items are still relevant to assessing the lack of marketability attributes of a subject family partnership interest. They included

- Analysis of the company's financial statements
- Company's divided policy to determine whether an investor will receive a fair rate of return
- The nature of the company, its history, its position in the industry and its economic outlook
- Company management
- Amount of control in transferred shares
- Restrictions on transferability of the stock
- Length of time an investor must hold the stock before a profit can be realized
- A company's redemption policy
- Costs associated with making a public offering

Assessment of the Combined Discount

A review of commentators in the appraisal and legal profession provides perspective on the current environment for combined discount levels. In addition, certain senior IRS officials have weighed in on the issue.

Few commentators dispute that the empirical data available can support some very large discounts – possibly in excess of 50% for small limited partnership interests in non-distributing real estate partnerships. However, the view of some experts in the field is that it may not be in their client's best interest to promulgate maximum discounts, due to the increased probability of IRS audit and the associated time, money, and energy costs. As discussed earlier, in an audit situation, the IRS will likely attack issues in addition to the discounts such as the validity of the partnership's business purpose and the timing of the partnerships formation among others.

As a sanity check, some appraisers compare the aggregate equity cash flow of the partnership to the aggregate non-marketable minority value to calculate an effective yield. This yield is then assessed for reasonableness in light of the risk of the investment.

An article in the May 28, 1998 edition of Taxes on Parade quotes William C. Sabin, an IRS senior technician reviewer, Passthroughs and Special Industries branch, as saying that a 20% discount on family partnerships funded with family business assets would not be abusive. It appears that IRS is likely to show some

tolerance for family partnerships funded with closely held stock as part of their overall trend towards presenting a more pro family-business posture.

Elements of a Family Partnership Narrative Report

Drafting the narrative report is the next step after completing the valuation analysis associated with appraising an FLP interest. The narrative report is written on behalf of the client; however, the ultimate target audience for most FLP reports is the Internal Revenue Service. There are aspects of the relationship between clients and the IRS that are adversarial, arising from the fact that any amount of tax not paid by a taxpayer is less revenue to the Treasury. The appraiser has the difficult yet crucial role of reaching an unbiased, objective opinion of value and convincing all parties that the conclusion reached is reasonable. The tool to achieve this objective is the narrative report. The appraiser must be able to show that at each major decision point he or she has been reasonable in judgment and thinking. The following describes the various aspects of a well-documented FLP narrative report.

Establish the Engagement Background

The report should establish who the client is (e.g., the attorney, a general partner, or a limited partner) as this may prove important in establishing the availability of attorney-client work product privilege. The report should be clear as to (1) what exactly is being appraised, (2) whether the premise is minority or control value, (3) the date of the valuation, and (4) the purpose and intended use of the appraisal.

Describe the Nature and History of the Partnership

The report should state fundamental information relating to the formation of the partnership, including (1) the date the partnership was formed, (2) the state the articles of partnership were filed in, (3) the location of the partnership's headquarters, and (4) the duration of the partnership.

The business purpose of the partnership should be clearly stated in the report. As discussed earlier, the IRS has attacked the validity of some family partnerships due to the lack of substantive business purposes beyond tax avoidance. Clients should seek the advice of s qualified estate tax attorney in ensuring that their partnerships have substantive non-tax business purposes.

The underlying assets of the partnership should be described. As discussed earlier, the composition of the underlying assets will influence the selection and weighting of the empirical data used to quantify net asset value adjustments. If there are multiple asset classes, the weightings of these various asset types should be made clear to the reader.

The ownership and capitalization of the partnership should also be discussed, including identifying the general and limited partners and their respective interests.

The operating history of many FLP's is very limited. However, consideration should be given to the partnership's historical and forecasted cash flow along with the history and prospects for cash distributions. A partnership with a history of providing limited partners with cash distributions will likely

have mitigated lack of control and marketability discounts regardless of the restrictive wording of the partnership agreement.

Describe the Partnership's Governing Instrument

The FLP narrative report should state the key provisions of the partnership governing instrument which influence the rights and restrictions of general and limited partnership interests. In his book entitled Guide to Business Valuations, Jay Fishman lists several key articles of a governing instrument

- The nature of management rights of each unit holder
- The extent of voting and other rights of each unit holder
- The restrictions on transferring units
- The method(s) to allocate income and loss
- The cash distribution requirements
- The ability of the limited partners to withdraw from the partnership

Describe the Valuation Methodology Employed

The report should state clearly why the selected approaches and methods were employed. In utilizing the adjusted book value approach, the appraiser should discuss the process of deriving the partnership's unadjusted net asset value and then discuss the derivation of the appropriate adjustments. The narrative report should explain how the specific facts and circumstances surrounding the subject interest, including the partnership agreement and the partnership's operating history, were considered in working with the empirical market data. In

addition, the narrative report may also need to address the impact of Internal Revenue Code Chapter 14 and applicable state law as part of the correlation process. IRC Chapter 14 and state partnership law are discussed later in this report.

Conclusion and Tests of Reasonableness

The report should be clear as to the application of the net asset value adjustments and the derivation of the partnership's aggregate non-marketable minority value. As discussed earlier, some appraisers assess the partnership's cash flow to aggregate non-marketable minority value as part of testing the reasonableness of their conclusion. Additional information to consider for inclusion includes a summary of the market data utilized, restricted stock and pre-IPO studies, and the qualifications of the appraisal firm and the appraiser.

Chapter IV

THREATS TO FAMILY PARTNERSHIP VALUATION DISCOUNTS

Threats to Family Partnerships

Recent actions of the Internal Revenue Service suggest that the IRS wants to reduce or eliminate family partnerships due to the perceived threat to the U.S. transfer tax base. The following will discuss ways the IRS is attacking FLP's, including a discussion of each method, the conceptual framework, and key rulings and Tax Court precedent.

IRS assaults on FLP's are categorized as follows:

- ***Attacks on the Validity of the Partnership Entity***. Such attacks have taken a legal position that the only motivation for the formation of the partnership was tax avoidance. Thus, the IRS has invoked the concept of "substance over form" to negate valuation discounts by collapsing the contribution and transfer transactions using the step transaction doctrine.
- ***Application of the Special Valuation Rules of IRC Chapter 14***. Family partnership agreements typically contain restrictions on the limited partner's rights to force liquidation or sell his or her interest. Such restriction's are critical to achieving discounts from net asset value, however, must be ignored under IRC Section 2703 unless the

partnership meets a three-prong test. The IRS has implied that many family partnerships will not meet these tests, thus rendering them nothing more than a device or "sham" to avoid or reduce transfer taxes.

- ***Legislative Attacks***. The Treasury Department, of which the IRS is a part, incorporated provisions in President Clinton's fiscal 1999 budget that would have eliminated valuation discounts except for "active businesses."
- ***Litigation and Other Harassment***. The IRS understands that taxpayers, threatened with expending enormous amounts of time, money, and energy in a litigated matter with the government, may opt for more conservative estate planning techniques than family limited partnerships.
- ***Valuation Adequacy Challenges***. The IRS has adopted a business plan that involves increased emphasis on gift tax examinations, including instructing revenue agents to look for valuation issues and gathering more information about the use of discounts on gift tax filings. The IRS has become more aggressive in attacking the adequacy of family partnership valuation analysis.

Attacks on the Validity of the Partnership Entity

Establishing that a viable entity has been formed is a key aspect of transfer tax planning. In a series of 1996 and 1997 Tax Advice Memorandums (TAM's), the IRS asserted that transactions involving the contribution of property to a family partnership and subsequent gifts of partnership interests were devoid of substance. The result was that the partnerships were disregarded for estate tax purposes and the discounts on the limited partnership interest transfers rejected.

The following TAM's involved family partnership transactions where the IRS denied valuation discounts using the "substance over form" doctrine:

- TAM 9719006
- TAM 9719007
- TAM 9723009
- TAM 9725002
- TAM 50127-96
- TAM 246145-96
- TAM 9719006

An analysis of these TAM's indicates a number of common characteristics. First, they were all "last illness" partnerships, meaning that the formation of the partnership, contribution of assets, and transfer of interests occurred shortly before the senior family member's death. The IRS used this pattern of facts to bolster their argument that the sole purpose of the partnership was tax avoidance. In implying that the transactions lacked substance, the IRS

noted that the assets that were contributed to the partnership would have been conveyed to the same offspring both with and without the family partnership vehicle.

Estate of Elizabeth B. Murphy v. Commissioner

The main U.S. Tax Court precedent cited by the IRS in these TAM's was Estate of Murphy v. Commissioner, T.C. Mem. 1990-472. In this case, the taxpayer went from a 51.41% controlling interest to a 49.65% minority interest position in a closely held corporation 18 days prior to her death. The taxpayer claimed a minority discount in valuing the 49.65% interest included in the decedent's estate.

The U.S. Tax Court refused to accept the valuation of the 49.65% block of stock on a minority basis, effectively rejecting the valuation discounts (Gibbs 43). The Tax Court concluded that the only apparent motivation for the transfers was to reduce federal transfer tax, noting that there was no evidenced of any other business purpose for the transfers (43).

Understanding the facts and circumstances surrounding a specific Tax Court ruling is critical in assessing the relevance of the case to any other situation. In the Murphy case, the decedent was chairman of the board of the company both before and after the transfers (Lavoie). The transfers were to her two children, who were also active in the business. The Tax Court noted "during the 18-day period between the lifetime gifts of the stock to decedent's two children and her death, decedent continued to be chairman of the board and her two children held the top two management positions. We believe that all concerned intended

nothing of substance to change between the time of the transfer and the time of her death, and nothing of substance did change" (qtd. in Lavoie).

Another fact influencing the Tax Court's position was that there was testimony in the case that the sole purpose of the transfers was to obtain valuation discounts on the stock at her death (Lavoie). The facts and circumstances of the Murphy case resulted in the IRS's "substance over form" argument carrying the day in Tax Court.

TAM 50127-96

An analysis of TAM 50127-96, one of the "last illness" TAM's released by the IRS, illustrates how the IRS has used the Murphy ruling to deny family partnership valuation discounts.

In TAM 50127-96, a family partnership was formed two days prior to the decedent's death. The decedent was terminally ill at the time of the partnership formation. Revocable and marital trust assets, consisting of marketable securities and real property that would have been includable in the decedent's gross estate, were contributed to the family partnership prior to her death. The underlying assets contributed to the partnership by the trusts controlled by the decedent totaled approximately $2.3 million. Transactions were executed such that the children took back a 2.0% general partner interest in exchange for an approximately $66,000 cash contribution. The trusts took back a 98% limited partnership interest in exchange for the $2.3 million asset contribution. The trusts' interests were subsequently valued on the decedent's estate tax return at

approximately $1.2 million, reflecting a 48.0% discount from the net asset value of the underlying assets contributed to the partnership.

In TAM 50127-96, the IRS addressed the issue of what is the proper treatment of the decedent's partnership interests for transfer tax purposes. The IRS stated their view that the valuation of the trust's partnership interests should not reflect discounts for lack of control and marketability; rather, it should be based on underlying net asset value.

The IRS cited the following similarities between the facts of the TAM and the Murphy case: (1) the transactions were intra-family transfers, (2) the formation of the partnership and contribution of assets in exchange for partnership interests took place near the time of the decedent's death, and (3) the trust assets would have passed to the same individuals, in the same proportions, under both the terms of the trusts and the terms of the family partnership.

The IRS used the facts of the TAM to conclude that "the only discernible purpose for the partnership arrangement was to depress the value of the partnership assets as these assets passed through the decedent's gross estate. Nothing of substance was intended to change as a result of the transactions". (TAM 50127-96).

Citing the Estate of Murphy case, the IRS concluded that

> It is well established that transactions having no purpose or effect to the transfer other than to reduce taxes are disregarded for federal tax purposes. As was the case in Estate of Murphy, the entire transaction must be viewed as a single testamentary

> transaction occurring at the decedent's death. Accordingly, any decrease in value resulting from the creation of the partnership must be disregarded. (TAM 50127-96)

There are several lessons which can be learned from Estate of Murphy and the recent spate of "last illness" TAM's. The most critical is that these rulings do not in of themselves impinge on the viability of FLP's as a whole. The extremely aggressive tax planning used in these cases offers lessons in key aspects of FLP structuring.

Ideal candidates for FLP's are those who are in good health and are capable of making decisions on their own without the use of a power of attorney. The most critical lesson from the recent TAM's is the importance of establishing valid non-tax business purposes for the formation of the partnership. In an article entitled "Family Entity Valuation Discounts: What's the Prudent Practitioner to Do?", Richard Lavoie lists various non-tax partnership purposes including

- Maintenance of Family Ownership of Property
- Protection for Family Assets from Creditors of the Individual Family Members
- Facilitation of the Management of Assets
- Facilitate Fractional Interest Transfers
- Pooling of Assets to Maximize Economic Return

The other lesson from Murphy and the TAM's is that Tax Court rulings and IRS technical advice memoranda are very "facts and circumstances"

orientated, and thus the facts surrounding any specific case take precedent over previous rulings. For example, the Tax Court rejected the IRS's "substance over form" argument in a 1995 ruling involving the Estate of Anthony J. Frank v. Commissioner.

In this case the decedent owned a 50.3% interest in a closely held corporation. Shortly before his death, the decedent's son used power of attorney privileges to transfer an 18.0% block of stock to the decedent's wife. Both the decedent and the decedent's wife passed away shortly thereafter. The Tax Court was asked to rule on the validity of minority discounts applied to both the retained stock of the decedent and the 18.0% block in the wife's estate. Both estates were successful in their argument that the size of the transferred block (18.0%) was evidence that non-tax motives were at work. If the motivation had been merely tax avoidance, a .50% block could have been transferred (Lavoie).

The Importance of Proper Partnership Formation and Operation

The IRS has also shown that it will attack the validity of family partnerships on the basis of poor formation and operation practices. A 1997 Tax Court ruling in the Estate of Dorothy Schauerhamer v. Commissioner highlights the importance of operating the partnership as an entity distinct from the taxpayer.

The following description of the events and transactions in the Schauerhamer case was compiled from an article in the August 1997 edition of Shannon Pratt's Business Valuation Update entitled "Deposits of FLP Income to Personal Bank Account Cause Disallowance of Gifts" and from an article by

Owen G. Fiore, JD, CPA, entitled "Greater Due Diligence Required of Tax Lawyers in Planning Entity-Based Valuation Discounts."

In the Schauerhamer case, the decedent formed a family partnership and contributed commercial real estate in exchange for general and limited partnership interests after learning she had a terminal illness. Gifts of limited partnership interests were made prior to her death. On the estate tax return, the gifted amounts were excluded and the remaining partnership interests were valued at discounts from net asset value.

The Tax Court judge accepted the FLP's validity and the contribution of the assets to the entity (Fiore). However, the judge noted that the decedent had kept control of all partnership income in her own personal bank account until her death. Thus, the decedent had combined FLP and personal income and had failed to keep separate records of the FLP's operations (Kimball 2). Thus, the Tax Court judge found that the partnership agreement had not been adhered to and that the decedent had failed to relinquish control over the assets contributed to the partnership entity. Therefore, IRC section 2036 was invoked, which requires that the value of assets over which a decedent retains control at death be included in the decedent's estate.

<u>Overview of Chapter 14 of the Internal Revenue Code</u>

Chapter 14 of the Internal Revenue Code was enacted in 1990 and consists of Sections 2701 through 2704 of the Code. The rules of Chapter 14 were made law primarily to curtail certain intrafamily wealth transfer strategies which were deemed abusive of Congress's intent in the areas of transfer taxation and valuation (Reeves et al. 11-44).

While Revenue Ruling 59-60 established fair market value as the standard of value for federal tax purposes, the valuation rules of Chapter 14, when applicable, effectively supersede the fair market value standard. The effect has been to create a standard of value applicable to certain intrafamily transfers which is a hybrid of the fair market value standard, namely the 'tax value' standard (Gibbs 1).

Wealth transfer planning using family partnerships inherently involves the transfer of partnership equity interests amongst family members. Therefore, it is important that an appraiser of such equity interests be aware of how the rules of IRC Chapter 14 can impact a fair market value determination.

Curtis W. Elloit, a tax lawyer in the firm of Culp Elloit & Carpenter, P.L.L.C, points out that appraisers should not be expected, as part of a valuation assignment, to issue opinions about the application of tax law to the valuation of property interests, including interests in general and limited partnerships. However, he notes that Chapter 14 has had the effect of blurring the line between

application of appraisal, tax and state law principles. He also notes that uncertainty surrounding the resolution of these issues can cause the factual basis of a valuator's opinion to be uncertain. Elloit concludes that appraisers involved in valuing family entity equity interests need to maintain a high level of familiarity with IRC Chapter 14 and recently decided opinions of the U.S. Tax Court (Business Valuation Update, October 1997).

The following is a description of IRC Sections 2701 through 2704, including their relevance to family partnership planning.

IRC Section 2701

IRC Section 2701 had its primary impact on a traditional estate planning technique known as the "estate freeze" (Blase). An estate freeze is a method to transfer a business to the next generation using a combination of common and preferred stock (or general and limited partnership interests). The objective of an estate freeze is to remove the future appreciation of the business from the estate of the senior family member, allow the senior family member to retain some degree of control over the business, and minimize the gift tax consequences of the transfers. IRC Section 2701 curtailed the effectiveness of the estate freeze technique in certain situations. However, there are ways to "plan around" the application of IRC Section 2701 in a family partnership situation (Blase).

IRC Code Section 2701 was enacted to combat a traditional estate planning technique used by closely held business owners known as an estate freeze. In a typical estate freeze, a corporation is first recapitalized using preferred and common stock. Preferred stock has attributes similar to debt.

While providing an income stream to its holder, it does not significantly appreciate in value as a company grows, unlike common stock. Subsequent to the recapitalization, the common stock was gifted to younger family members with the senior family member retaining the preferred stock. The intent was to shift the future appreciation in value of the Company out of the estate of the senior family member, while enabling the senior family member to retain an income stream from the Company.

Since gifts of common stock were made in an estate freeze, one objective was to minimize the transfer tax value of the common stock. One technique was to assign voting and preferential liquidation rights to the preferred stock retained by the senior family member, with the intent to reduce the value of the common stock (Reeves, et al. 5-2). Upon the senior family member's death, such preferred stock rights would lapse, reducing the value of the preferred stock for estate tax purposes (5-2).

Congress viewed the above estate freeze technique as abusive of their intent in the transfer taxation area, giving rise to the anti-freeze provisions of IRC Section 2701 in 1990.

IRC Section 2701, when applicable, will, with some exceptions, result in "zero" value being assigned to the retained interest, thus increasing the value of the transferred interest and, therefore, the gift tax value of the transferred interest (Blase). If IRC Section 2701 is not applicable, then the fair market value standard can be utilized without being superseded by the "tax value" standard.

IRC Section 2701 applies when there is a transfer of a subordinated equity interest to a family member, and, immediately after the transfer, the senior family member holds certain liquidation or distribution rights (Reeves 5-3).

How applicable is IRC Section 2701 to family partnership transactions? It must be considered because most FLP transactions involve senior family members transferring limited (subordinated) partnership interests within the family while retaining an equity interest in the partnership. However, there is a key exception in the Tax Code which will frequently allow for the avoidance of IRC Section 2701 application.

The practitioner must determine whether the senior and subordinated (i.e., general and limited partner interests) are "of the same class", as defined by the Internal Revenue Code. If the retained interest is "of the same class or proportional to the class of the transferred interest" then the special tax valuation rules of IRC Section 2701 will not apply (Fishman 14-19).

In his book entitled Today's Hottest Device in Estate Planning: The Family Limited Partnership, Allan R. Eber, J.D, LL.M notes that IRC Section 2701 allows for "non-lapsing" differences, such as management and liability limitations, to be ignored in making the "same class" determination. In addition, differences in voting rights can be ignored (Fishman 14-19). Thus, a general partner interest that possesses the power to (1) manage the entity's affairs and (2) vote on entity matters while (3) remaining liable for partnership debt will be considered in the same class as a limited partner interest for purposes of IRC Code Section 2701. However, if the general partner retains the right to subject the

limited partner to partnership debt or has different cash distribution rights, IRC Section 2701 may apply (Fishman 14-19).

Thus, careful planning will result in IRC Section 2701 not being applicable to the valuation of most family partnership interests.

IRC Section 2702

IRC Section 2702 imposes gift tax valuation rules on certain transfers in trusts to family members.

IRC Section 2703

The IRS's assertion that the provisions of IRC Section 2703 are applicable to family partnership valuation has thrust the details of this code provision into the spotlight. When IRC Section 2703 was originally enacted in 1990, Congress was concerned that provisions in buy/sell and partnership agreements were being used in intrafamily situations to create artificially low equity interest values for transfer tax purposes. IRC Section 2703 states that the restrictive provisions in these agreements which depress value will be ignored unless the agreement passes three tests. These tests focus on the "arm's length" nature of the terms of the agreement and whether the agreement has a bona-fide business purpose.

At issue currently is how broadly the Tax Court will interpret that application of IRC Section 2703 in the family partnership arena. A broad interpretation might force some family partnership interests to be appraised at net asset value, under a tax value standard, for transfer tax purposes, as opposed to on a fair market value, adjusted net asset value basis, which allows for consideration of the partnerships cash flow and the application of discounts.

Understanding the impact of Internal Revenue Code Section 2703 on FLP's begins with reviewing a typical approach to the initial funding and capitalization of a family partnership.

Subsequent to the formation of the partnership, property is contributed to the partnership in exchange for partnership interests. These can take the form of either general or limited partnership interests. For example, a senior family member could take back a 98% limited partnership interest and a 1% general partnership interest in exchange for his or her capital contribution. A junior family member could take back the remaining 1% partnership interest for a nominal capital contribution. At this point the FLP has been capitalized.

The assets that have been contributed to the partnership are subject to restrictions. These restrictions, as stated in the partnership agreement, reduce a limited partner's ability to derive full benefits from both the underlying partnership assets and his or her partnership interest. It is these restrictions that support the validity of discounts from underlying net asset value when estimating the fair market value of a partnership interest.

The IRS has asserted that Internal Revenue Code Section 2703 allows for these restrictions to be ignored for transfer tax purposes unless the partnership agreement meets each part of a three-pronged test, stated as follows [IRC Sec. 2703(b)]:

- It is a bona fide business arrangement

- It 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
- At the time the agreement or restriction is created, its terms are comparable to similar arrangements entered into by persons in arm's length transactions.

In a series of Technical Advice Memoranda (TAM's), the IRS has expressed their view that certain partnerships do not meet all of the tests under IRC Section 2703(b).

One argument that the IRS has put forth, in certain situations, is that the partnership does not represent a bona-fide business arrangement. For example, in TAM #249992-96, issued in July 1997, a decedent funded a partnership with $400,000 of farmland, and took back partnership interests appraised for $170,000 less. The IRS commented "It is inconceivable that Descendent would have accepted, if dealing at arm's length, a partnership interest purportedly worth only a fraction of the value of the asset he transferred" (TAM 249992-96). The IRS cited Saltzman v. Commissioner, T.C. Memo. 1994-641, where the Tax Court outlined relevant factors for determining whether an intra-family transaction could be considered a bona fide business transaction.

The IRS has also labeled as a "device" partnerships where, in their opinion, the only apparent purpose of the formation and transfer of the partnership interests was avoidance of tax. This interpretation highlights the importance of establishing valid non-tax business purposes.

IRC Section 2704

The enactment of IRC Section 2704 in 1990 resulted from two landmark taxpayer victories in the area of intrafamily partnership transfer taxation. In each case, large discounts were allowed from the partnership's underlying net asset value. The concept underlying the discounts was "lost value". In these cases, the partners contributed property to a partnership, and then agreed to "restricted liquidation rights" with respect to their partnership interests. In valuing subsequent transfers of partnership interests, large discounts were reported from net asset value on the transfer tax returns.

IRC Section 2704 takes aim at two contractual liquidation restrictions in intrafamily entity arrangements that have depressing effects on value; (1) IRC Section 2704(a) addresses lapsing liquidation rights and (2) IRC section 2704(b) addressees restrictions on liquidation rights.

There are "plan around" strategies that can minimize the adverse provisions of IRC Section 2704 in the family partnership area. However, similar to IRC Section 2703, there is on-going debate as to whether the U.S. Tax Court and Congress will adopt a broad interpretation of IRC Section 2704 which would negatively impact family partnership wealth transfer planning in some situations.

The IRS cited IRC Section 2704 in several of the 1997 FLP TAM's. IRC Section 2704(b)(1) provides that for transfer tax purposes, the value of a partnership interest transferred to a family member must be determined without regard to any "applicable restriction" (Lipschultz and Zysik). An applicable restriction is generally that which is more restrictive than state law. Therefore,

IRC Section 2704(b) effectively provides that restrictions in governing instruments which are more restrictive than state law will be treated as no more restrictive than that law in computing valuation discounts.

The effect of IRC section 2704 is to reduce the ability of wealth transfer planners to utilize restrictions on liquidation rights to suppress the value of family partnerships established in certain states (Lipschultz and Zysik).

Chapter V

THE FUTURE OF FAMILY PARTNERSHIPS

This report will conclude with (1) current developments in the IRS's war on FLP's; (2) advice on how to minimize exposure to IRS scrutiny; (3) an update on the Treasury's legislative attack on FLP's.

Current Developments in the IRS's War on FLP's

Current developments through October 1998 in the IRS's on-going battle with FLP's include

- Assertions from the IRS that deny the availability of the annual gift tax exclusion on transfers of certain family limited partnership interests
- Increase focus by the IRS on auditing "abusive" FLP situations
- Closer examinations by the IRS of "valuation adequacy"

IRS Attempts to Deny the Availability of the Annual Gift Tax Exclusion on Transfers of Certain Family Limited Partnership Interests

In order for transfers during life to qualify for the annual gift tax exclusion, the gift has to be that of a "present interest." The IRS defines a present interest gift as entitling the donee to the "immediate use, possession or enjoyment" of the income and corpus components of the gift (IRC Section 2503b). Future interests gifts do not qualify for the annual gift tax exclusion.

In TAM 9751003, the IRS held that the substance of the cash distribution and transfer provisions of a certain family partnership governing instrument resulted in the limited partnership interest transfers not qualifying as present interest gifts.

In addressing the cash distribution provisions, the IRS noted that the limited partnership agreement granted the general partner "absolute discretion" to withhold cash distributions from partners "for any reason whatsoever" (Schneider and Fox). In the IRS's view, the wording of the cash distribution provision created a future, rather than present, interest gift.

The IRS also stated their view that the corpus component of the transfer was not a present interest gift, due to the transfer restrictions contained in the limited partnership agreement. The transfer restrictions denied a limited partner the right to transfer his or her interest without general partner approval. The result, according to the IRS, was that the corpus component of the gift constituted a future interest.

In a May 1998 article published in The Tax Advisor, Terri Holbrook-Lawrence advocates that annual exclusions can be obtained if a governing instrument allows for mandatory annual distributions of distributable cash flow, while allowing the general partner to retain responsibility to decrease distributable cash flow for operational and interest reserves (Holbrook-Lawrence).

Philip Schneider, JD, CPA, ASA, and Shawn Fox, CPA, in a February 1998 article, published in Shannon Pratt's Business Valuation Update, advised on drafting the transferability restrictions of governing instruments with an objective

of qualifying for the annual exclusion. They indicated that governing instruments with transfer provisions no more restrictive than providing general partners with a right of first refusal with respect to the transfer of limited partnership interests should qualify.

Appraisers of family partnership interests need carefully to evaluate the provisions of governing instruments, such as those above, in assessing the magnitude of discounts from net asset value applicable to a subject interest.

IRS Focuses on "Abusive" FLP Situations

A flurry of statements by senior IRS officials in May 1998 put taxpayers on alert that the Service intends to crack down on what it perceives as a "rising level of abuse" in the family partnership area. The IRS views "abusive" situations as those involving (1) dramatic discounts on FLP's funded with liquid assets, (2) FLP's lacking a legitimate business purpose, and (3) FLP's formed subsequent to the senior family member's "last illness."

In May 1998, the IRS formed a task force on FLP issues. Expected actions resulting under the guidance of this task force include an increase in the number of gift and estate tax return examinations. As of July 24, 1998, 14% of the transfer tax returns under examination involved FLP issues (Wall Street Journal). The new requirement of IRS Gift Tax Form 709, calling for increased disclosure of the use of valuation discounts, is also facilitating the IRS's audit efforts.

IRS actions indicate that, once a FLP is selected for audit, the Service will challenge not only the valuation adequacy but also other issues such as the validity of the business purpose of the partnership and the timing of its formation.

The IRS has taken a view that the validity of the business purpose of the partnership is linked to the type of assets with which the partnership is funded The IRS seems to have taken a more lenient view of FLP's funded with family business interests and rental and commercial real estate as opposed to those funded with investment securities.

FLP's formed subsequent to the senior family member's last illness have also been ripe targets of the IRS in 1997 and 1998, due to the IRS's perception that the only motivation for formation was tax avoidance.

The IRS and taxpayers also have numerous cases pending before the U.S. Tax Court involving FLP's. This has led some practitioners to believe that a landmark Tax Court decision could occur in the near future.

Avoiding IRS Scrutiny in FLP-Based Transactions

Certain taxpayers utilizing FLP-based wealth transfer planning will be subject to less scrutiny, litigation, and general harassment than others. The IRS appears to select gift tax returns for audit, in part, based on the size of the valuation discounts from net asset value. As noted earlier, once a return is under examination, the IRS will review the valuation adequacy and other issues relating to the viability of the partnership entity. Therefore, it stands to reason that the use

of less aggressive discounts may enable a taxpayer to reduce exposure to IRS scrutiny.

The use of a qualified appraisal firm is critical to successful wealth transfer planning using family partnerships. When a FLP is funded with closely held stock or real estate, a qualified appraisal firm should be engaged to value the underlying assets. Furthermore, a firm with individuals experienced in financial valuation should be retained for the valuation of the family partnership interests. A taxpayer taking these steps is far more likely to withstand a valuation adequacy challenge than those who do not.

The importance of establishing valid non-tax business purposes for the partnership cannot be overstated. The partnership's governing instrument should set forth the underlying reasons for the partnership's formation. A well-written appraisal report should demonstrate how the operating history of the partnership validates that the partnership has acted in accordance with its underlying purposes.

In addition, taxpayers should implement their wealth transfer plan while they are healthy, not wait until their deathbed to enter into transactions. Not only does this reinforce the validity of non-tax formation purposes, but it also enables taxpayers to remove additional appreciation from their estates and maximize transfers via annual exclusions.

The Current Legislative Attack on Family Partnerships

President Clinton's 1999 budget proposal calls for eliminating valuation discounts from net asset value for family limited partnerships where the underlying assets are primarily passive in nature. This would reduce the scope of wealth transfer planning with family partnerships. Family partnerships funded with closely held stock and real estate would likely be impacted the least, with partnerships funded with investment securities and personal real estate being impacted more greatly. If the proposal passes, there would be no transfer tax advantages to FLP transactions where the partnership was funded with non-active partnership assets.

Kevin Flatley, director of estate planning at BankBoston, noted that typically changes like these are effective as of the date of the proposal (qtd. in Kadlec). Therefore, FLP transactions executed prior to a formal proposal date will likely be grandfathered; however, those transactions occurring subsequent to the date of the proposal would likely be rejected.

Bob Packwood, former chairman of the Senate Finance Committee, stated in a September 1998 interview that he believes passage of the proposal is likely, subsequent to the Congressional elections in November 1998. (Business Valuation Update, September 1998). However, others have noted that the Republican-controlled Congress is in general opposition to tax revenue raising White-House proposals such as this (Nations Business).

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