THE VALUATION OF FAMILY LIMITED PARTENRSHIPS AND OTHER CLOSELY HELD INVESTMENT COMPANIES

Business Appraiser Role

The business appraiser is a member of the estate planning team. He or she works in concert with the family, tax and estate planning counsel, and other advisors. Ideally, the business appraiser joins the team prior to the formation of the family limited partnership ("FLP") or other closely held investment company. This allows the appraiser to offer suggestions on alternative entity structuring possibilities, relating to appropriate valuation methodology. In addition, by joining the team early in the process, the appraiser gains a much better understanding of the overall estate plan, and the details surrounding the FLP. This, in turn, allows the appraiser to provide a more informed supportable appraisal. For purposes of this text, although the FLP is the primary focus of the discussion, the valuation of other closely held investment companies will follow a similar process.

1. Valuation Process Overview: The process of valuing interests in FLPs typically adheres to the steps outlined below. (Individual steps are discussed in more detail later in this text.)

a. Define Standard of Value

It is critical that a well-defined purpose be established early in the assignment. The purpose and other circumstances will dictate the standard of value to apply, and will influence the nature and format of the appraiser's work product. When valuing FLPs for transfer tax purposes, the standard of value applied is "fair market value," which is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of the relevant facts."

b. Specify Interest Valued

It is also critical to identify the specific interest to be valued. Is a general or limited partner's interest being valued? Is the interest a controlling or non-controlling interest? The size and nature of the interest to be valued affects the appraiser's methodology and may also influence the magnitude of the valuation adjustments applied.

c. Determine Date of Value

Since the fair market value of an FLP can vary over time, it is also necessary to establish a specific date of value. If the matter involves estate tax settlement, the valuation date is typically set at the date of death. In the case of gifting FLP interests, the date of value is ideally set at or near the gifting date.

d. Appraise Underlying Assets

The assets of many FLPs consist largely of real property. In conjunction with the partnership appraisal, a formal appraisal of the underlying real property is conducted, taking care to insure that the value date and other parameters for the real estate appraisal are consistent with those defined for the partnership valuation. In the case of cash or marketable securities, asset values are usually derived from brokerage account statements or from similar documents.

e. Determine Unadjusted Value

Once the underlying asset values have been determined, the next step is to determine the aggregate unadjusted value of the partnership. (The term "unadjusted value" is used herein to describe a step in the process of arriving at the fair market value of a specific partnership interest. It is an indication of the FLP's aggregate value, derived prior to the application of any appropriate adjustments for factors such as lack of control or lack of marketability.) For those partnerships primarily holding real property, the approach used in determining the unadjusted value is usually the adjusted net worth of the partnership. This is derived by adding the appraised fair market values of the underlying assets, and subtracting any liabilities (such as mortgage debt).

f. Analyze Economic Environment

The financial performance of a partnership, and therefore its value, is directly influenced by economic conditions. As such, it is important to examine the economic factors relevant to the FLP. For example, assume a partnership holds ranch land in Merced County, California, and that this property is leased for grazing cattle. It would be important in this case to understand both the local real estate market for ranch property, and the beef cattle industry. Also, you would want to know if the property was employed in its highest and best use, which raises questions such as: Can the partnership increase its return by developing the land for housing or commercial uses? Will the zoning, location, and economic realities support such a change? Is the general partner likely to make such changes?

g. Analyze Partnership Agreement

It is critical that the appraiser, with guidance from legal counsel, understand the partnership agreement when valuing an interest in an FLP, particularly when determining the appropriate valuation adjustments. The partnership agreement defines pivotal issues of control and transferability of partnership interest.

h. Analyze Financial Performance

While the unadjusted values of FLPs can be determined in many instances by their net asset values, the financial performance of individual FLPs also plays and important role. The level of past and expected future income, together with past and expected future distributions to partners, will influence the appraiser's opinion of an interest's fair market value. (This is particularly true when the FLP interest being valued lacks the power to compel dissolution of the partnership.)

i. Finalize Fair Market Value

After application of appropriate valuation adjustments, an opinion of value (usually of fair market value) can be developed. This opinion is expressed as of a specific date, for a specific partnership interest, and for a specific purpose.

j. Produce A Narrative Report

The appraiser's final work product should be a narrative report which conforms to the Uniform Standards of Professional Appraisal Practice and which contains, at a minimum the following elements:

- Purpose of assignment and specific interest valued.
- Valuation date.
- Definition of standard of value applied.
- Appraiser certification and liming conditions.
- Partnership description (Partners, nature of business, date formed, location, etc.).
- Description of partnership assets and discussion of financial performance.
- Discussion of relevant economic conditions and specific implication for the subject partnership.
- Determination of unadjusted value, including explanation of methodology applied and calculations made.
- Discussion of valuation adjustments, including rationale, supporting empirical evidence, and the specific facts and characteristics of the subject partnership which give rise to the adjustments.
- Opinion of value (usually fair market value).
- Sources of information used.
- Qualifications of appraiser.

Unadjusted Value

Before determining the type and magnitude of valuation adjustments to apply, the unadjusted value of the FLP must be established. The unadjusted value of a FLP is influenced primarily by the value and nature of its underlying assets. Because many FLPs hold real property and/or marketable securities rather than operating entities, the basis of unadjusted value is commonly the fair market value of the FLP's underlying assets less any liabilities.

1. Valuation Methodologies

Revenue Ruling 59-60 (as amplified by later rulings) provides guidelines for valuing interests in closely held entities for estate and gift tax purposes. Sec. 4 of this Revenue Ruling outlines the specific factors that should be considered in each case. Sec. 5 discusses the weight that should be accorded to the various factors. For operating companies, greater weight is to be applied to earnings and dividend paying capacity. However, Sec. 5(b) states that "adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity." These guidelines are consistent with accepted valuation methodology and form a reasonable basis for valuing interests in closely held entities. Since most FLPs have the characteristics of investment or real estate holding companies, the adjusted net worth method prescribed by Sec. 5(b) of Rev. Rul. 59-60 is most commonly applied. A current, formal appraisal of the partnership's underlying assets is the starting point for determining the unadjusted value of most FLPs. In the case of real property, a licensed, local real estate appraiser, with expertise in the type of property being appraised, is ideally retained. The real estate appraisal report should be conducted for the same purpose, and as of the same value date, as the partnership appraisal. Once completed, copies of the real property appraisal(s) are provided to the FLP appraiser. The value of any other assets, commonly cash or marketable securities, are obtained from brokerage account statements or other appropriate means. It is critical that the value of these other assets be determined as of the specified valuation date.

Occasionally, a FLP will hold interests in other closely held entities, such as C-corporations or other partnerships. (A limited partnership cannot hold interest in an S-corporation.) If these other entities are operating companies -- as opposed to investment or real estate holding companies -- other (primarily earnings based) valuation methods are applied. (The focus of this text is on those FLPs that operate primarily as investment entities. As such, the valuation methods applicable to operating entities are not addressed in detail.)

After determining the fair market value of the FLP's assets, any attendant liabilities must be identified. The fair market value of these liabilities, as of the valuation date, is then subtracted from the underlying asset value to determine the partnership's net worth. This unadjusted partnership value becomes the foundation for determining the fair market value of the partnership or of a specific partnership interest. The next step is to apply appropriate valuation adjustments.

Valuation Adjustments

The net asset value of a FLP is often used to determine the unadjusted value of the entire partnership. However, to realize this value, an investor would need to be able to gain access to, and liquidate, the underlying assets of the partnership. If limited partners were afforded this level of control, a limited partnership interest might well be worth a pro rata share of the partnership's net asset value. However, this is not a valid approach because of two primary factors: 1) A family limited partnership interest is illiquid relative to many other investments, such as marketable securities; and 2) A limited partner cannot control the distribution of the economic benefits of the partnership, nor can he or she access or liquidate the partnership's underlying assets.

These two factors are commonly known as the limited partner's "lack of marketability," and "lack of control," respectively. (Virgina Z. Harwood, 82 T.C. 239 (1984) and Estate of Samuel I. Newhouse, 94 T.C. 193 (1990) contain widely cited discussions concerning the application of these two factors.)

1. Lack of Marketability

   The basis for marketability adjustments for FLP interests arises from a variety of factors, which include the following:

   a. There is no public market for FLP interest, and most FLPs are unlikely ever to become publicly traded. FLPs usually have few partners, which narrows the pool of potential buyers of interests in the partnership. In addition, the other partners usually are not obligated to purchase the interest of a limited partner who wishes to sell his or her interest.

FLP agreements often impose restrictions on the transfer of FLP interest.
FLP agreements often require the consent of the other partners before a substitute limited partner may be admitted.
FLP s often invest in undiversified assets, decreasing the attractiveness of interests in the partnership.
The assets held by FLPs often produce little income. (And FLPs therefore often make small distributions to limited partners relative to the underlying net asset values of the partnerships.)

b. Lack of Control

The basis for control adjustments for FLP interests arises from a range of factors, which includes:

Limited partners generally cannot control the day-to-day management or operation of partnership.

Limited partners generally cannot control the amount or timing of income distributions to limited partners.
Limited partners do not have visited claim on the underlying assets of the partnership, and they usually cannot compel the dissolution of a partnership and the liquidation of its underlying assets.
Its is usually very difficult for limited partners to remove general partners.
It is usually very difficult for limited partners to amend a partnership agreement.
These factors are manifested in individual FLP agreements and in the default provisions of state partnership law.

c. Undivided interests in real property

FLPs occasionally hold undivided interests in real estate. An undivided interest in real estate is an arrangement in which two or more parties own a fractional interest in one real property, with all parties having an equal right to make use of and enjoy the entire property. These co-tenants also have the right to sell their respective interests.

There is a variety of empirical evidence and several court cases which support the application of valuation adjustments for undivided interests in real property. These valuation adjustments are brought about by several characteristics of undivided interests. These include lack of control, potential expenses of partitioning, illiquidity, unavailability of financing, and the risk inherent in purchasing a relatively illiquid asset. These factors would substantially decrease the amount that an informed purchaser would be willing to pay for an undivided real property interest, compared to the interest's pro rata share of the entire property's fair market value.

The rationale and available empirical data providing compelling support for the application of valuation adjustments to undivided interests in real estate. However, the applicable to a given FLP interest is usually lower than at indicated by the empirical data because many of the factors that impact the adjustment for undivided interests in real estate are already included in the adjustments for lack of marketability. As such, undivided interests in real estate usually warrant only an incremental adjustment to the previously derived marketability adjustments. (Also note that the magnitude of the incremental valuation adjustment for undivided interests in real estate will be influenced significantly by the portion of the FLP's total assets that are held as such undivided interests.)

d. Layering of Adjustments

As mentioned earlier, FLPs will occasionally hold interests in other closely held entities. Interests in these other entities are commonly subject to their own valuation adjustments for lack of control and lack of marketability. By placing these interests in a FLP, it may be appropriate to apply an additional layer of valuation adjustments. However, the magnitude of this additional adjustment will generally be lower than the adjustment typically applied to other partnership assets, particularly real property.

The layering of adjustments in this manner is viewed by some as an "aggressive" estate planning strategy. From an appraiser's perspective, there is solid evidence to support the application of an additional, albeit smaller, layer of adjustment. Further discussion of this issue may be found in a number of relevant court cases.

e. Application of Adjustments

Lack of marketability and lack of control adjustments are applied sequentially. They are not added together. For example, a 30 percent lack of marketability adjustment and a 20 percent lack of control adjustment will not yield a 50 percent adjustment to the unadjusted value of the partnership. To illustrate, suppose a FLP owns a single asset, the family farm, and that the partnership has a net asset value of $3 million. If we apply the 30 percent and 20 percent adjustments indicated above, the fair market value of the partnership, on a minority basis, would be calculated as shown in the chart below. As illustrated, the total adjustment is $1,320,000, or 44%. This can also be calculated as follows: 1-(1?30%)(1-20%) = 44%.

Unadjusted Value $3,000,000
Less 30% Marketability Adjustment -$900,000
$2,100,000
Less 20% Control Adjustment -$420,000
Fair Market Value of a 100%
Interest; Minority Basis $1,680,000

Major Factors

The valuation adjustments for a particular FLP interest will vary according to --- and must be supported by --- the specific facts and circumstances associated with the partnership. The primary factors that influence the magnitude of these adjustments are as follows:

1. Level of Control of Limited Partners

By definition, FLPs provide limited partners with little or no control over the operation or underlying assets of the partnership. However, the specific construction of the partnership agreement can afford varying degrees of control to the limited partners. Logically, the less control afforded the limited partners, the greater the discount for lack of control.

2. Limitations on Transfers

Most FLPs place at least some restrictions on the transfer of limited partnership interests. All else being equal, greater transfer restrictions will support greater adjustments for lack of marketability.

3. Levels of Earnings and Revenues

As cited earlier, Sec. 4.02 of Rev. Ruling 77-287 states that among the factors related to the magnitude of marketability adjustments were the level of the companies' revenues and earnings. Generally speaking, the lower a partnership's earnings and revenues (particularly relative to its underlying asset value), the greater the adjustment for lack of marketability.

4. Number of Partners

An FLPs existing partners represent one potential pool of buyers for interests in the partnership: All else being equal, a smaller number of partners will support greater marketability adjustments.

a. Nature of Underlying Assets

In addition to forming the basis for the FLP's adjusted net worth, the underlying assets can also influence the magnitude of the valuation adjustments applied. As an extreme example, assume there are two different partnerships that share the same characteristics with the exception of their underlying assets. One holds income-oriented marketable securities with a fair market value of $1 million. The other holds undeveloped land, which produces no income, but also has a fair market value of $1 million. Even though the underlying asset values are the same, the partnership holding the unimproved land would warrant larger adjustments for lack of marketability. This disparity is driven by the differences in the marketability of the underlying assets as well as the differing earnings available to a prospective investor.

5. Relevant Economic/Industry Environment

An investor is primarily concerned with the future returns on his or her investments. As with any business entity, an FLP's financial performance, and hence its potential returns to investors, will be greatly influenced by its economic and industry environment. All else being equal, a partnership operating in a favorable economic and industry environment will warrant lower adjustments for lack of marketability.

a. Size of Interest Being Valued

The relevance of this factor is driven to a large extent by the partnership agreement. Assume, for example, that an FLP agreement allows a simple majority in interest of the limited partners to replace the general partner. In this situation, a 51 percent interest has materially greater control than a 50 percent interest. Accordingly, a smaller - or perhaps no - control adjustment would be applied to the 51 percent interest in this example.

b. Specific Valuation Assignment

The purpose of the assignment primarily influences the standard of value to be applied. Although "fair market value" is the standard applied in estate and gift matters, in a context such as dissolution or a private sale, standards such as "liquidation value" or "investment value" may be more appropriate. The standard of value applied can have a significant impact on the resulting opinion of value.

Recent Developments

FLPs vs. LLCs. Most of the states have enacted statutes which enable the formation of Limited Liability Companies ("LLCs). LLCs are the subject of much current discussion and are considered by many to be an attractive alternative to the FLP. Some of the valuation implications of these LLCs remain unclear, however. Many argue that the valuation adjustments that can be applied to LLCs will be lower than those attributable to FLPs. This issue centers around IRC Sec. 2704(b). This code section applies to both LLCs and FLPs and states that, for estate and gift tax valuation purposes, transfer and liquidation restrictions in the operating agreement (LLCs) or partnership agreement (FLPs) will be disregarded if: the entity is family controlled, and the restrictions are more restrictive than governing state law.

In the case of California, for example, the LLC statue gives greater withdrawal and liquidation rights to LLC members, compared to those typically afforded members in an LLC operating agreement. As such, many argue that the transfer or liquidation restrictions in a family LLC's operating agreement must be ignored for transfer tax valuation purposes. (This issue is not as great for FLPs in this example because the California Corporations Code applies greater transfer and liquidation restrictions to limited partners than to members of LLCs. Following this logic, the fair market value of interests in a family LLC may be closed to the interest's pro rata share of the LLC's net asset value. In other words, lower valuation adjustments! This issue has yet to be resolved, and will certainly vary from state to state. Until the IRS provides further guidelines, or the issue is tested in Tax Court, the valuation implications of 2704(b) will likely remain unclear for family LLCs.

1. 1994 "Anti-Abuse" Regulations

The "anti-abuse" rules have caused a considerable stir in the valuation and estate planning communities. The rule, Treas. Reg. Sec. 1.701-2, was finalized on Dec. 29, 1994. Almost immediately thereafter, in Jan. 1995, the IRS partially revoked this regulation in IRS Ann. 95-8. This partial revocation of Sec. 1.701-2 eliminated any transfer tax effect and specifically revoked the two FLP examples that were initially included in the regulation. However, the IRS has made it clear that it will continue to scrutinize FLPs carefully, with particular attention paid to valuation adjustments. This again highlights the importance of a well-supported partnership appraisal.

a. Court Reaffirms Importance of Specificity in Appraisals

A significant new case brings renewed attention to the need to obtain well-reasoned, supportable valuations. The subject case is Bernard Mandelbaum, Et. Al. V. Commissioner, T.C. Memo, 1995-255 (decided June 12, 1995). This matter involved a consolidated group of estate tax cases in which the magnitude of marketability adjustments for interests in closely held stock was being contested. The Court stated in this matter: "Having found limited refuge in the opinions of either expert, we proceed to determine the value of the marketability discount." The Court then outlined nine specific factors that it considered in arriving at its own opinion of an appropriate marketability discount. The factors themselves were not unusual. (They are consistent with widely accepted valuation methodology.) However, the case is illustrative of the Court's expectations with regard to the valuation factors that must be considered. It also demonstrates the Court's insistence that appraisals provide specific evidence in support of valuation adjustments, and that this evidence must be demonstrated to be relevant to the specific interest being valued.

Conclusion

The use of FLPs can be an important element in succession planning, investment strategy and wealth preservation. However, the IRS and the courts are applying increasing scrutiny to the use of valuation adjustments in determining the fair market value of FLPs. The courts have spoken loudly and clearly that an appraisal must articulate the specific facts, circumstances, and empirical evidence that support the valuation opinions offered. To effectively utilize the FLP, one must assemble a team of professionals which combines the skills of the financial advisor, lawyer, accountant, and business appraiser. Working with this team, the appraiser must analyze the specific facts and circumstances associated with a given FLP, and then apply the appropriate valuation methodologies and empirical evidence to produce a supportable opinion of value.