

Family Limited Partnerships
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Presentation Outline

- I. FLP Description
- II. Valuation
- III. Market Approach
- IV. FLP Examples
- V. Court Cases

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I. FLP Description

- Asset holding entity vs. operating company
- Only immediate family members own equity
- Only immediate family members manage the business
- Parents want control / Children want control

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REASONS FOR FORMING A FLP

- ◆ Lawsuits
- ◆ Management
- ◆ Education
- ◆ Gifting Attributes
- ◆ Tax Benefits

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What to Consider When Forming a Partnership
Source: A Practical Guide to Avoiding Pitfalls by Stephanie Loomis-Price, Baker Botts

1. Review and negotiate the partnership agreement's terms in regards to its:
 - n Purpose
 - n Management Structure
 - n Management Powers
 - n Compensation to Managers
 - n Investment Policy
 - n Distribution Policy
 - n Transfer Restrictions
 - n Partnership Term
 - n Use of Partnership Assets

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What to Consider When Forming a Partnership (Cont.)

2. Consider having separate counsel for each partner
3. Ensure that attachments to the partnership agreement are complete
4. Prepare deeds and transfer documents prior to formation date
5. File required formation documents to the relevant state authorities
6. File for employer identification number

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What to Consider When Forming a Partnership (Cont.)

- 7. Create partnership bank/brokerage accounts in a timely manner
- 8. Engage a partnership accountant
- 9. Ensure partners receive partnership interests in proportion to value of assets contributed to partnership
- 10. Consider amortizing partnership set-up fees
- 11. Amend partnership percentages as quickly as possible after formation

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What to Consider When Forming a Partnership (Cont.)

- 12. Be prepared to produce documents in your files to the IRS
- 13. File tax returns for each year in existence
- 14. File any annual/bi-annual registration statements required by relevant state authorities
- 15. Comply with terms of the partnership agreement
- 16. Ensure that partnership assets are not co-mingled with partners' assets

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What to Consider When Forming a Partnership (Cont.)

- 17. Keep the charity involved
- 18. Ensure that partnership takes over management of partnership assets
- 19. Comply with loan terms
- 20. Make any distributions pro rata
- 21. Avoid multiple transactions between partners and the partnership

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What to Consider When Forming a Partnership (Cont.)

- 22. If partner dies or transfers interest in partnership, consider whether partnership should make I.R.C. 754 election
- 23. If partner dies, do not write checks out of partnership's accounts to creditors of deceased partner
- 24. Hire advisors experienced with valuation issues

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What to Consider When Forming a Partnership (Cont.)

- 25. Ensure that taxpayer documents transfer of partnership interest
- 26. Confirm that appraisal accurately identifies nature of interest to be valued
- 27. Determine fair market value of assets of partnership
- 28. Obtain independent appraisal from a qualified appraiser
- 29. Review appraisal report closely for facts

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II. Valuation

Determine the fair market value of an ownership interest in the FLP

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REASONS FOR A BUSINESS VALUATION

- A) Merger/Acquisition/Fairness Opinions
- B) Family succession planning/Estate and gift taxes
- C) Buy-Sell Agreements

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Fair Market Value

The amount at which the equity interest of the partnership would change hands between a willing buyer and a willing seller, each having reasonable knowledge of the relevant facts, neither being under any compulsion to act.

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IRS Revenue Ruling 59-60

The following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

- ◆ The nature of the business and the history of the enterprise from its inception.
- ◆ The economic outlook in general and the condition and outlook of the specific industry in particular.
- ◆ The book value of the stock and the financial condition of the business.
- ◆ The earning capacity of the company.
- ◆ The dividend-paying capacity of the company.

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IRS Revenue Ruling 59-60

- ◆ Whether or not the enterprise has goodwill or other intangible value.
- ◆ The price, size, and type of interests sold previously and the size and type of the interests to be valued.
- ◆ The market price of interests or stocks issued by companies in the same or a similar line of business and actively traded in a free and open market, either on an exchange or over-the-counter.

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Steps in the Valuation Process

- ◆ Gather Company data
- ◆ Site Visit / Management Interview
- ◆ Research economic and industry information
- ◆ Analyze company financial statements & appraisals
- ◆ Tests of Valuation
- ◆ Discounts, Premiums and Value Conclusion

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Information needed

- ◆ Partnership agreement and any amendments
- ◆ 5 years of tax returns or financial stmts.
- ◆ Real estate appraisals or other asset appraisals
- ◆ Brokerage statements
- ◆ Expected distribution policy

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Adjustments to Financial Statements

- ◆ Balance Sheet
 - Separate assets by type
 - Market Value versus Book Value
- ◆ Income Statement
 - Non-recurring items
 - Add backs
 - Deducts
 - Tax Adjustments

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Net Asset Value

- ◆ Total market value of partnerships' assets less liabilities
- ◆ Net value that could be realized by a controlling interest, excluding liquidation costs

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Approaches to Business Valuation

- I. Asset-Based Approach
- II. Market Approach
- III. Income Approach

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I. Asset-Based Approach

- ◆ Subject ownership interest should be able to cause the sale of company's assets
- ◆ More appropriate for valuing controlling interests

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I. Asset-Based Approach

- w Adjusted Book Value Method
- w Liquidation Value Method

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II. Market Approach

- w Previous Sales of or Offers for the Company's Equity
- w Sales of Similar Companies
- w Sales of Stock of Publicly Traded or Publicly Listed Companies
- w Rules of Thumb

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II. Market Approach

- ◆ Focuses on how comparable noncontrolling interest are priced in the open market in terms of:
 - Dividend yields
 - Price-to-NAV ratios
 - Price-Earnings/cash flow ratios
- ◆ Identify comparable entities in terms of:
 - Asset type
 - Debt Structure
 - Distribution characteristics
 - Liquidation horizon

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III. Income Approach

- ◆ Quantify future benefits
- ◆ Determine appropriate rate of return to discount future benefits to present value

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III. Income Approach - Two Methods

- ◆ Capitalization of Earnings
- ◆ Discounted Cash Flow ("DCF")

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Capitalization of Earnings

- ◆ Used when earnings:
 - Historically have been stable or
 - Grow at a predictable rate

$$= \frac{NCF}{(k-g)}$$

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DCF

- ◆ Used when earnings are expected to grow at different rates
- ◆ Can be used to predict future liquidation

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Rate of Return

- ◆ Return expected and required from a particular investment

Publicly Held Limited Partnerships	20.2%
Small Company Stocks	17.4%
Real Estate Investment Trusts	14.7%
Large Company Stocks	12.3%
Long-Term Corporate Bonds	6.2%
Long-Term Government Bonds	5.8%
U.S. Treasury Bills	3.8%

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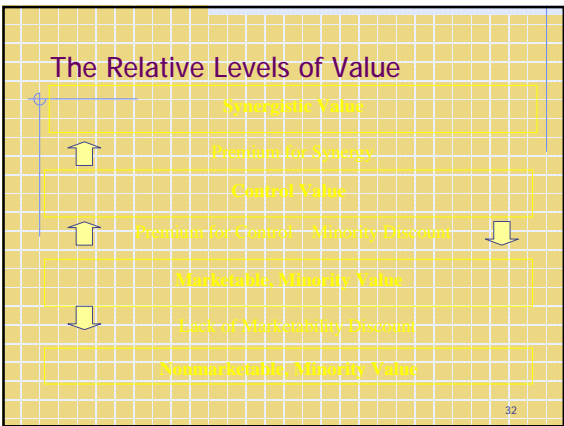
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Correlation and Conclusions

	<u>Minority</u>	<u>Control</u>
<u>Approach</u>		
Asset		Liquidation
Market	Public Company	Merger
Income	DCF/Cap of earnings	

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- ### Synergistic Premium
- ◆ Reflects the value to a specific buyer
 - ◆ Synergistic buyer can pay more due to perceived earnings benefits from a merger
 - ◆ Not appropriate consideration in determining "fair market value"
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What Discounts/Premiums Apply in Valuing Shares in a Closely-Held Company

Control Premium

- Appoint or remove management or determine their compensation;
- Set policy or change the course of business;
- Acquire or liquidate assets;
- Make acquisitions of other companies;
- Liquidate, dissolve, sell, or recapitalize the company;
- Registering the company's stock for an initial public offering;
- Force the sale of the stock to the Company (stock redemption);
- Determine the amount and timing of any dividends to shareholders; or
- Amend the Articles of Incorporation/ LP Agreement.

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What Discounts/Premiums Apply in Valuing Shares in a Closely-Held Company

Minority Discount

A minority interest in a closely held corporation is generally held to be worth less than its proportionate share of the value of all the outstanding shares. This is because minority shareholders generally cannot control the company. The magnitude of a minority discount depends on the shareholder's ability to exercise any or all of a variety of rights typically associated with control.

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Premium for Control and Discount for Minority Interest

- ◆ Size of control premium is influenced by many factors but most frequently falls in the 10% to 40% range.
- ◆ This equates to a minority discount range of 9% to 29%.

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Marketability Discount

- ◆ Securities of privately owned companies are not readily tradable on an established exchange and do not have access to an organized secondary market and may require a discount for their lack of marketability.

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Quantification of the Marketability Discount

- ◆ Restricted Stock Studies
 - ◆ Pre IPO studies
 - ◆ FMV Restricted stock database
 - ◆ Rate of return studies

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Tax advantages

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Levels of Value

Control Value-\$8MM	Ownership of 100% of the voting shares
Minority discount-7.5%	
Marketable, Minority Value-\$7.4MM	ESOP or publicly traded
Lack of Marketability discount-35.0%	
Nonmarketable, Minority Value-\$4.8 MM	Gifts
Overall discount-40%	

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Minority/Lack of Marketability discounts

Justification for the discounts is real!

Minority owner does not have the power to:

- *Liquidate or sell the entity
- *Transfer assets
- *Declare dividends/distributions
- *Receive non prorata dividends/distributions
- *Change investment policy/management
- *Loss of control = loss of liquidity

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Family Limited Partnership Example ("FLP")

	December 31, 2007
Real estate	5,000,000
Investment securities	3,000,000
Asset Value	8,000,000

Estimated Annual Appreciation:	
Real estate	6%
Investment securities	10%

	December 31, 2017
Real estate	8,954,238
Investment securities	7,781,227
Asset Value	16,735,465

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Estate tax with no Planning

Estate taxes:		
Exemption/couple	7,000,000	
<hr/>		
Estate tax rate	45%	
<hr/>		
Asset Value	16,735,465	
Exemption/couple	<u>7,000,000</u>	
Taxable amount	9,735,465	
Tax	4,380,960	

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Set up Family Limited Partnership and make donations

	December 31, 2007	
Asset value of FLP	8,000,000	
Discount	40%	
Fair Market Value after discount	4,800,000	
<hr/>		
Donations	2,000,000	
<hr/>		
Parents own	2,800,000	58%
Kids own	<u>2,000,000</u>	42%
Total Fair Market Value	4,800,000	100%

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Fair market value in 2017

	December 31, 2017	
Real estate	8,954,238	
Investment securities	<u>7,781,227</u>	
Asset Value	16,735,465	
<hr/>		
Discount	40%	
<hr/>		
Fair Market Value after discount	10,041,280	
Parents own	5,857,413	58%
Fair Market Value of parents' interests	<u>5,857,413</u>	

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Estate Tax with planning

Exemption/couple	7,000,000
Amount used in gift	<u>(2,000,000)</u>
Net exemption/couple	5,000,000
Estate tax rate	45%

Fair market value of parents' interests	5,857,413
Net exemption/couple	5,000,000
Taxable amount	857,413
Tax	385,836

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Estate Tax with planning

Parents have passed \$16MM of assets to their children and incurred \$385,836 in estate taxes, versus \$4,380,960 they would have incurred with no planning.

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Summary

Noncontrolling ownership interests maybe subject to substantial discounts per interest versus their pro-rata share of the controlling value. This allows families to minimize estate taxes.

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Other Valuation Issues

- ◆ Capital Gains tax
- ◆ GP interests
- ◆ Tiered entities

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Built in Capital Gains (Taxes)

- ◆ Only on C Corps or S Corps with unexpired taxable gains

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Valuing GP Interests

- ◆ If interest can control partnership directly interest will be worth pro-rata value or may have small discount
- ◆ Depends on length of time it would take to:
 - Replace general partner
 - Sell assets and liquidate partnership

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Valuing Tiered Entities

- ◆ Two Factors to consider:
 1. Investor in FLP already in noncontrolling situation so may not be necessary to discount interest further to increase rate of return
 2. Determine history of distributions

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III. Market Approach

- ◆ Analyzes recent sales of comparable public entities
- ◆ Publicly traded operating companies are not used as comparison
- ◆ Closed-end funds, REITS and publicly-held real estate limited partnerships are used

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Selection of Comparable Entities

- ◆ Important to identify comparable noncontrolling interests
- ◆ Includes the inability to:
 - Force sale of assets and liquidation
 - Control investment decisions
 - Control compensation for management
 - Control distribution of any income generated

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Closed-End Funds

- ◆ Publicly traded
- ◆ Actively traded price
- ◆ A lot of Information available including:
 - n SEC filings
 - n Historical Performance
 - n Professional opinions by analysts

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Open-End vs. Closed-End Funds

- ◆ Open-End:
 - n Issue new or redeem existing shares at anytime
 - n Trades at NAV of its underlying asset
- ◆ Closed-End:
 - n Offers fixed number of shares
 - n Once all shares are sold no further inflows or outflows
 - n Value of shares determined by supply and demand in a secondary market

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Closed-End Fund - Level of Discount

- ◆ Trade at higher discounts from NAV when one or more exist:
 1. Underperformance relative to benchmarks
 2. New funds or fund with little historical or hard to obtain info
 3. Higher levels of risk
 4. No set distribution policy

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Closed-End Funds

- ◆ Similar to FLP owning marketable securities
- ◆ Owner of a noncontrolling interest cannot:
 - Control distribution of any income generated
 - Control reinvestment of earnings
 - Sell underlying assets
 - Force liquidation of partnership
 - Withdraw from partnership
 - Control compensation for management

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Selecting Appropriate Closed-End Funds

<u>Asset Category</u>	=	<u>Comparable Closed-End Fund</u>
Cash, CD's, Money Market Accounts	=	US Treasury Funds
Municipal Bonds and Tax Exempt Bond Mutual Funds	=	Municipal Bond Funds
Corporate Bonds and Bond Mutual Funds	=	Investment Grade Bond Funds
Individual Stocks and Equity Mutual Funds	=	Equity Funds

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Comparing FLP to Closed-End Fund

- ◆ Factors to consider include:
 - Size
 - Management
 - Lack of current information
 - Diversity of portfolio
 - Frequency of audited Financial Statements
 - Set distribution policy
 - Annual tender offers or repurchase shares

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Real Estate Investment Trust ("REIT")

- ◆ Corporation or trust that uses pooled capital of many investors to purchase and manage income producing property and/or mortgage loans.
- ◆ Traded on major exchanges like stocks
- ◆ Offer special tax considerations

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REIT Types

- ◆ Residential/Apartments
- ◆ Office
- ◆ Shopping Center
- ◆ Regional Malls
- ◆ Industrial
- ◆ Lodging
- ◆ Self Storage
- ◆ Health Care
- ◆ Other

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Average Discount vs. Average Yield

Source: Canaccord Adams REIT Review 6/15/07

<u>REIT category</u>	<u>Average Discount</u>	<u>Average Yield</u>
Diversified	5.4%	7.1%
Office	5.4%	6.3%
Retail	0.6%	6.8%
Self Storage	-13.0%	5.6%
Lodging	9.4%	7.9%

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Real Estate Limited Partnership (RELP)

- ◆ Formed to build new structures and generate income from existing property, or profit from capital appreciation of undeveloped land
- ◆ Bought and sold through specialized brokers which comprise the informal secondary market
- ◆ Most RELPs comprised of income-producing real-estate

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RELP Types

<u>Types of Assets</u>	<u>% of Market</u>
Real Estate	80% - 85%
Equipment	10% - 15%
Oil & Gas	2%
Cable TV Systems	2%
Miscellaneous	2%

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Average Discount vs. Average Yield

Source: *Direct Investment Spectrum 2005*

<u>LP Category</u>	<u>Average Discount</u>	<u>Average Yield</u>
Equity Distributing (no to low debt)	19%	7.6%
Equity Distributing (moderate to high debt)	24%	5.3%
Equity Non-Distributing	42%	0.0%

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REITS vs. RELPS

REITS	RELPS
◆ Large portfolios	◆ Small portfolios
◆ Traded on recognized securities exchanges	◆ Rely on general partner
◆ Self-managed and self-administered, full time officers and employees	

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REITS vs. RELPS (Cont.)

REITS	RELPS
◆ Board of directors, usually independent	◆ No oversight board
◆ Infinite-life corporations	◆ Finite-life entities with specified liquidation date
◆ Required to distribute 90% of taxable income	◆ No distribution requirement

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REITS vs. RELPS (Cont.)

REITS	RELPS
◆ Easier access to capital	◆ Limited capital sources available
◆ Growth-oriented entities	◆ Acquire initial properties and do not acquire additional ones
◆ Pass-through entities for tax purposes	◆ Taxed on amount of dividend distribution actually received

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Sources of Information

- ◆ Morningstar Principia Pro Closed-End Fund
- ◆ Partnership Profiles, Inc.
- ◆ The Wall Street Journal/Barron's
- ◆ Ibbotson Associates Inc. Stocks, Bonds, Bills and Inflation

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IV. FLP Valuation Examples

1. Marketable Securities
2. Real Estate

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1. Marketable Securities

	<u>Market Value</u>		<u>Expected Return</u>	=	<u>Income</u>
Bonds	\$ 3,000,000	x	7.0%	=	\$ 210,000
Stocks	\$ 7,000,000	x	10.0%	=	\$ 700,000
	<u>\$ 10,000,000</u>				<u>\$ 910,000</u>
Expenses					\$ 100,000
Net Cash Flow					\$ 810,000

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1. Marketable Securities (Cont.)

INCOME APPROACH

	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
Net Cash Flow	\$ 810	\$ 810	\$ 810	\$ 810	\$ 810	\$ 8,020
PV Factor	0.91	0.82	0.75	0.68	0.62	0.56
	\$ 736	\$ 668	\$ 607	\$ 551	\$ 501	\$ 4,502
Aggregate Noncontrolling, Marketable Value						\$ 7,565

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1. Marketable Securities (Cont.)

MARKET APPROACH-NAV TEST

	NAV		Price to NAV		Estimated Value
Corporate Bonds	\$ 3,000,000	X	0.875 : 1	=	\$ 2,625,000
Equities	\$ 7,000,000	X	0.825 : 1	=	\$ 5,775,000
Estimated Noncontrolling, Marketable Value					\$ 8,400,000

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1. Marketable Securities (Cont.)

MARKET APPROACH-YIELD TEST

	Income		Yield		
Bonds	\$ 210,000		7.0%	=	\$ 3,000,000
Stocks	\$ 600,000		12.0%	=	\$ 5,000,000
	\$ 810,000			=	\$ 8,000,000

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1. Marketable Securities (Cont.)

◆ Tests of Value

DCF	\$7,565,000
NAV	\$8,400,000
Yield	\$8,000,000

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2. Real Estate

◆ Comparable companies were analyzed based on REITS/partnerships:

- Owned and managed equity interests in real property
- Property type
- No to low levels of debt
- Yield
- Not announced definitive plans to liquidate

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2. Real Estate (Cont.)

NAV TEST

	REIT	RELP
NAV of subject partnership	25,000	25,000
Selected Price/NAV ratio	0.95	0.75
Aggregate Noncontrol, Marketable Value	23,750	18,750

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2. Real Estate (Cont.)

Avg. Price-to-FFO REITs	10.6		
Effective Capitalization rate	$\frac{1}{10.6}$	=	9.0%
Plus Specific Risk Premium		+	3.0%
Adjusted Capitalization Rate			12.0%

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2. Real Estate (Cont.)

YIELD TEST		
	REIT	RELP
Funds from Operation of subject partnership	2,500	2,500
Selected distribution yield	0.12	0.15
Aggregate Noncontrol, Marketable Value	20,833	16,667

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2. Real Estate (Cont.)

MARKETABLE MINORITY VALUE INDICATIONS		
	REIT	RELP
NAV test	23,750	18,750
Yield test	20,833	16,667
Conclusion	22,500	17,750

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Factors that Influence Lack of Marketability Discounts

Factor	Influence
Liquidation time frame	Shorter time frame-low er discount
Income Yield	Higher yield-low er discount
Distribution policy	High distributions-low er discount
Number of partners	Large number of partners-low ers discount

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Marketability Discount

	REIT	RELP
Marketable, Minority Values	22,500	17,750
LOM discount	35% 7,875	25% 4,438
Nonmarketable, Minority value indications	14,625	13,313
Conclusion		\$ 14,000
Discount to NAV		44.0%
Yield		17.9%

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V. Court Cases

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Case 1

Strangi v. Commissioner	11/30/00	DLOC	DLOM	TOTAL
Taxpayer Expert		25.0%	25.0%	43.75%
IRS Expert		8.0%, 5.0%	25.0%, 15.0%	31.0%, 19.0%
Court		N/A	N/A	N/A

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Case 2

Hackl v. Commissioner	03/27/02	DLOC	DLOM	TOTAL
Taxpayer Expert				
IRS Expert		Decided on 2503 issues		
Court				

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Case 3

McCord v. Commissioner	05/14/03	DLOC	DLOM	TOTAL
Taxpayer Expert		22.0%	35.0%	49.3%
IRS Expert		8.3%	7.0%	14.8%
Court		15.0%	20.0%	32.1%

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Case 4

Temple v. United States of America - Ladera Land LP	03/10/06	DLOC	DLOM	TOTAL
Taxpayer Expert		25.0%	45.0%	59.0%
IRS Expert		Combined DLOC & DLOM 33.0% + additional incremental DLOM of 7.5%		
Court		Combined DLOC & DLOM 33% + additional incremental DLOM of 7.5%		

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Case 4 (Continued)

Temple v. United States of America - Boggy Slough, LLC	03/10/06	DLOC	DLOM	TOTAL
Taxpayer Expert		25.0%	45.0%	59.0%
IRS Expert		0% for majority interest	N/A	N/A
Court		N/A	N/A	60.0% for majority interest

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Case 4 (Continued)

Temple v. United States of America - Temple Partnerships	03/10/06	DLOC	DLOM	TOTAL
Taxpayer Expert		N/A	N/A	N/A
IRS Expert		3.3%-10.1%	12.5%	N/A
Court		3.3%-10.1%	12.5%	N/A

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Additional Sources of Information

1. Comprehensive Guide for the Valuation of Family Limited Partnerships, 3rd Edition
2. ASA Business Valuation Guidelines
3. AICPA / BV Valuation Guidelines
4. Valuing a Business – Shannon Pratt

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Family Limited Partnerships

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