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Family Limited Partnerships—Tax Court Demands More from Valuation Experts

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Over the past several years, the IRS has challenged transfers of family limited partnership interests by focusing on the elimination of discounts for minority interests based on legal arguments. These legal arguments primarily focused on the interpretation of Internal Revenue Code ("Code") Secs. 2703 and 2704. Based on the IRS's interpretation of these Code sections, the partnership agreement for family limited partnerships should be ignored for valuation purposes. Therefore, the taxpayer would not be entitled to a discount or, at the most, would only be allowed a very small discount from the partnership's net asset value.

Legal Argument

Under Code Sec. 2703, certain rights and restrictions of business agreements may be disregarded for valuation purposes unless each of the following three criteria are met:

1. The partnership must be a bona fide business arrangement.
2. The partnership interest cannot be a device to transfer ownership to members of the decedent's family for less than adequate consideration.
3. The terms of the agreement must be comparable to similar arrangements entered into by persons in arm's-length transactions.

Under Code Sec. 2704, restrictions on the liquidation of the partnership are to be disregarded for valuation purposes if the restriction in the partnership agreement is deemed to be an "applicable restriction." An applicable restriction as defined by Reg. §25.2704-2(b) is:

> a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction.

If a restriction is deemed an applicable restriction and disregarded under Code Sec. 2704, the transferred interest is to be valued as if the rights of the transferor are determined under the State law. The value of a limited partnership interest can be significantly higher if a restriction prohibiting liquidation of the partnership is disregarded.

Over the past two years, a number of estate and gift tax cases have been decided in favor of the taxpayer regarding these issues. Notable cases include *Estate of E.J. Church v. United States*[1] and *B.P. Kerr, et ux. v. Commissioner*[2]. In *Church*, the judge rejected the IRS's contention that Code Sec. 2703 should be interpreted to ignore the limited partnership agreement stating that:

> No case supports the Government's position, and nothing in legislative history, or the regulations adopted by the IRS itself, convince this Court to read into Section 2703 something that is not there. By its very nature, a partnership is voluntary association of those who wish to engage in business together, and upon whom the law imposes fiduciary duties. Term restrictions, or those on the sale or assignment of a partnership interest that preclude partnership status for a buyer, are part and parcel of the property interest created by state law. These are not the agreements or restrictions Congress intended to reach in passing I.R.C. §2703. Reviewing the legislative history, and construing I.R.C. §2703 with its companion statute I.R.C. §2704, it is clear that the former was intended to deal with below-market buy-sell agreements ….

In *Kerr*, the Court concluded that the partnership agreement did not contain restrictions on liquidation that constituted applicable restrictions within the meaning of Code Sec. 2704(b). The Court determined that the restrictions contained in the partnership agreement were no more restrictive than the limitations that generally would apply under Texas law.

Both of these family limited partnership decisions were significant victories for the taxpayer. These decisions, along with others, seem to have diverted the IRS's attention away from legal challenges and have caused them to focus more heavily on business valuations where the IRS has had more success.

Scrutiny Shifts to Business Appraisal

A recent article in *The Wall Street Journal* reported that the IRS's focus has now shifted toward family limited partnership business appraisals, stating, "*… the battle is over discounts.*"[3] Tax Court decisions over the past two decades indicate that judges are carefully examining not only the amount of discount taken but how the discount was derived. The Tax Court has consistently rejected experts' opinions that do not adequately evaluate the specific characteristics of the interest being valued. For example:

- 1983—*Estate of E.O. Sullivan v. Commissioner*— The Tax Court rejected the taxpayer's discount because the appraiser's analysis was not specific.[4]
- 1987—*Estate of N.L. Bell v. Commissioner*—"[The] petitioner must establish (1) the value to be discounted and (2) the amount of the discount. Both points are a matter of proof."[5]
- 1991—*N.N. Mooneyham v. Commissioner*—The tax court revealed its distaste for the calculation of discounts without empirical data.[6]
- 1991—*Estate of E.A. Berg v. Commissioner*—The Tax Court found the IRS appraiser's "analysis is persuasive because he relies on very specific studies of comparable properties." The Court also stated that the estate's appraiser "offers no analysis of the appropriate amount of the discount, and we therefore regard his appraisal as irrelevant."[7]

The Tax Court's scrutiny has been equally challenging for the valuation of interests in family limited partnerships.

Traditional Methodology Flawed

The vast majority of business appraisers use the cost approach to value family limited partnerships. This methodology generally includes calculating the net asset value of the limited partnership and deducting discounts for lack of control and lack of marketability. The Tax Court has been particularly critical of this methodology because of the difficulty in determining the discounts. For example, in *I.F. Knight v. Commissioner*,[8] the Court rejected the appraiser's calculation of a discount for lack of control because its derivation was unsupportable. In *Estate of E.H. Weinberg v. Commissioner*,[9] the court rejected the determination of a discount for lack of marketability citing that the appraiser "failed to adequately take into account certain characteristics of the subject limited partnership interest …."

Because a limited partnership is noncontrolling, a limited partner typically cannot exercise control over the sale of the assets of the partnership but can only look to the income-generating ability of the partnership. Therefore, appraisers should not rely solely on the cost approach for valuing family limited partnerships but should include methodologies that better take into account the distribution-paying capacity of the interest.

Empirical Methodology

The income and market approaches offer a more reliable way to value a family limited partnership by quantifying risk and return using empirical data. For example, using the income approach, an appraiser can forecast available cash flow generated by the investment and discount it to present value using a discount rate that reflects the risk of the limited partnership. As shown below, the discount rate increases as the risk of the investment increases. Risk, measured by volatility or the standard deviation of returns, for six types of investments is shown in Table 1.

The market approach is also useful to empirically determine the value of a privately held interest by using pricing multiples of publicly held investments. Revenue Ruling 59-60[10] states that the sale transactions for publicly held interests should be considered when valuing privately held interests. This is noted as follows:

> As a generalization, the prices of stocks which are traded in volume 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 corporations and industries ….

For family limited partnerships, price to net asset value multiples and price to earnings multiples can be derived using information published by Partnership Profiles, Inc. (www.PartnershipProfiles.com). Partnership Profiles, Inc. is a research company that provides transaction information on limited partnership interests that trade in the informal secondary market. Its three business valuation products in-

Table 1: Measurement of Risk

	Average Return	Standard Deviation
Venture Capital	45.0%	115.6%
Small Company Stocks	17.2%	25.0%
International Stocks	15.2%	21.6%
Large Company Stocks	13.3%	15.7%
Long Term Government Bonds	7.6%	11.4%
Treasury Bills	6.0%	2.7%

Source: The Wall Street Journal, March 23, 2000 clude the online Minority Interest Discount Database, *Comprehensive Guide for the Valuation of Family Limited Partnerships*[11] book and the *Partnership Spectrum* newsletter.

It is important to note that the income and market approaches are based on accepted financial theory, and it is this type of methodology that is used by investors in the capital market. Typically, investors do not apply general discounts to an investment's net asset value to determine value (i.e., cost approach). Rather, investors seek an objective financial ratio (e.g., rate of return or price to earnings ratio) to determine a value that will yield an appropriate rate of return based on the risks of the investment. Discounts from net asset value should only be used after a conclusion of value has been determined to check the reasonableness of the final value. Discounts from net asset value are also helpful in conveying a value to the client, but it should be noted that the discount is a result of a financial calculation and not a means to determine value.

New Data for Appraisers

As more and more appraisers adopt this empirical methodology, new information is being published to support the derivation of rates of return for the income approach and the determination of pricing multiples for the market approach.

Partnership Profiles, Inc. offers two sources of information. For the income approach, a study of expected rates of return for real estate partnership interests purchased in the secondary market was recently published in *Comprehensive Guide for the Valuation of Family Limited Partnerships*. The study examines the expected rate of return sought by third-party investors in hundreds of limited partnership transactions since 1994. A key premise of this book is that discounts for lack of control and lack of marketability are merely a result of the overall rate of return sought by an investor. Investors determine how much they will pay for an investment based on a rate of return that reflects the risk of the investment, not based on the discount from net asset value at which they can purchase the investment. In other words, while discounts from net asset value are a means to an end, that end is the rate of return sought by an investor.

For a number of years, business appraisers have been using discount information published by Partnership Profiles, Inc. in their Annual Discount Re-Sale Study. Perhaps the most important finding from the limited partnership rate of return study featured in *Comprehensive Guide for the Valuation of Family Limited Partnerships* is that while discounts from net asset value for interests in real estate partnerships trading in the secondary market have declined significantly over the past several years, the rate of return expectations of the investors purchasing these interests have not diminished as they have begun factoring shorter liquidation scenarios into their pricing models. Although these investors are paying higher prices than ever before relative to partnership net asset values, they have not lowered their rate of return expectations since they expect to realize capital gains from these partnerships based upon more near term liquidation time frames. This is clear evidence that investors base their valuations on rates of return and not discounts when buying noncontrolling partnership interests in the secondary market.

In addition to the rate of return study, Partnership Profiles, Inc. has now made available the supporting data used in its Annual Re-Sale Discount Studies in an online database. Appraisers can now access this data via an online database that includes an interface enabling appraisers to quickly retrieve valuable market data on 280 real estate partnerships. The partnership information can be downloaded into a spreadsheet for further analysis and also includes the partnership's most recent SEC 10K annual report.

Conclusion

In recent years, the Tax Court has consistently expressed a preference for the use of analytical techniques for the valuation of family limited partnership interests. One acceptable method is the income approach, which includes projections of net cash flow that are discounted to present value using a properly determined rate of return. The market approach is also supported, using pricing multiples from specific data of comparable publicly held entities.

Appraisers basing their valuations solely on the cost approach by primarily using discounts from net asset value run the risk of not being able to support the discount taken. When the focus of a family limited partnership valuation is concentrated on the return to the investor, the appraiser can estimate a value that is supported based on alternative rates of return and third-party transactions in the public market. ◆

End Notes

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1 *Estate of E.J. Church v. United States*, DC Tex., 2000-1 USTC ¶60,369.

2 *B.P. Kerr v. Commissioner*, 113 TC 450, Dec. 53,667.

3 Wall Street Journal, December 27, 2000.

4 *Estate of E.O. Sullivan v. Commissioner*, 45 TCM 1199, Dec. 40,015(M), TC Memo. 1983-185.

5 *Estate of N.L. Bell v. Commissioner*, 54 TCM 1123, Dec. 44,335(M), TC Memo. 1987-576. Also see *C.W. Ward v. Commissioner*, 87 TC 78, Dec. 43,178; *Estate of W.G. Andrews v. Commissioner*, 79 TC 938, Dec. 39,523.

6 *N.N. Mooneyham v. Commissioner*, 61 TCM 2445, Dec. 47,303(M), TC Memo. 1991-178.

7 *Estate of E.A. Berg v. Commissioner*, 61 TCM 2949, Dec. 47,420(M), TC Memo. 1991-279.

8 *I.F. Knight v. Commissioner*, 115 TC 506, Dec. 54,136.

9 *Estate of E.H. Weinberg v. Commissioner*, 79 TCM 1507, Dec. 53,753(M), TC Memo. 2000-51.

10 Rev. Rul. 59-60, 1959-1 CB 237.

11 Bruce A. Johnson and James R. Park.