



Family Limited Partnerships

THE REALITIES OF ESTATE PLANNING
WITH FAMILY LIMITED PARTNERSHIPS



Family Limited Partnerships

INTRODUCTION



The Realities of Estate Planning with FLPs

INTRODUCTION

- **Various entity structures used by taxpayers seeking asset protection and minimization of income and transfer taxes**
- ***Tax Reform Act of 1986*** – double layer of taxation
 - *Catalyst for popularity of “pass-through” entities*
 - Shift in income tax rates
 - Elimination of General Utilities



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INTRODUCTION

- **Types of pass-through entities**
 - *Proprietorships*
 - *Partnerships*
 - *S Corporations*



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INTRODUCTION

- **S Corporation Limitations**
 - *More restrictive and less flexible*
 - *Shareholder type and number*
 - *Single class of equity ownership*
 - *Difficult loan basis rules*



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INTRODUCTION

- **Partnerships**
 - *Offer greatest flexibility in planning for both business and transfer taxes*
 - *Opportunity to centralize family assets in one vehicle for control and management*
 - *Allows for discounted asset value transfers*



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- Introduction
- Types of Partnerships/Tax Guidance
- Mechanics and Benefits of Family Limited Partnerships
- IRS Battlegrounds
- Valuation Methods
- Valuation Discounts
- Working Example
- Relevant Court Cases



Family Limited Partnerships

TYPES OF PARTNERSHIPS & RELATIVE
TAX GUIDANCE AT FORMATION



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Partnerships**

- *Two primary structures*

- General partnership
- Limited partnership

- *Three additional entities have emerged*

- Limited liability partnership
- Limited liability limited partnership
- Limited liability companies



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Partnership**

- *A syndicate, group or joint venture, or other unincorporated organization of two or more individuals or entities through which any business, financial operation or venture is carried on, and in which the partners share in the profits and losses of that venture.*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

▪ **General partnership**

- *Comprised of two or more partners*
- *“Pass-through” entity – allows single level of taxation*
- *Generally not used for family wealth planning purposes*
 - Lack of limited liability
 - Control prerequisite cancels discount for lack of control
 - Allowing management by junior generation creates risk
 - Right to withdraw negates discount for lack of marketability



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

▪ **Limited partnership**

- *Single general partner and one or more limited partners*
- *General partner assumes liability; limited partners personal assets are protected from exposure to loss*
- *Limited partners are “passive investors,” allowing for greater discounts for lack of control*
- *Limited partners cannot control cash flow distributions, which can affect size of discount for lack of marketability*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Other limited liability entities (state law variations)**
 - *Limited liability partnerships*
 - *Limited liability limited partnerships*
 - *Limited liability companies*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **IRS Challenges**
 - *IRS tested the existence of partnerships used as an income-shifting device*
 - *IRS challenges focused on whether the partnership interest was acquired in exchange for “original” capital or “vital” services*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **IRS Challenges**
 - *IRS suggested that acquisitions of partner interests in exchange for property acquired by gift, or if the interest itself is acquired by gift, the interest would NOT be recognized*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Historical IRS challenges to partnerships**
 - *IRS Section 704(e)*
 - A person will be recognized as a partner for federal tax purposes IF he or she owns a capital interest in a partnership where capital is a material factor in the production of income, whether or not the partnership interest is acquired by purchase or gift from any other person.



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Historical IRS challenges to partnerships**
 - *IRS Section 704(e)*
 - Income allocable to the donee partner under the partnership will be includible in his/her taxable income
 - Interest in the partnership held by the donee must have been acquired in a bona fide transaction, or transfer will be deemed a tax avoidance transaction



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Family limited partnerships and valuation discounts**
 - *Standard of Value: “fair market value”*
 - The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is under no compulsion to sell, both parties having reasonable knowledge of relevant facts.



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **Family limited partnerships and valuation discounts**
 - *Two primary areas of risk in partnerships*
 - Control (or lack thereof)
 - Marketability (or lack thereof)
 - *Discounts for lack of control and lack of marketability are the primary mechanisms used to modify value for partnerships lacking in these attributes*
 - *IRS has history of challenging these discounts*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **IRS guidance to applying discounts**
 - *Revenue Ruling 93-12 (1993)*
 - Allows that lack of control will not be disallowed simply by virtue of family ownership
 - Drove popularity of use of family limited partnerships
 - *IRS tried to mitigate some of the tax advantages by issuing a TAM introducing a “swing vote” premium*



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TYPES OF PARTNERSHIPS & RELEVANT TAX GUIDANCE

- **IRS Attention**
 - *Note that discounts are one of the Internal Revenue Service’s primary areas of concern and are regularly examined*



Family Limited Partnerships

MECHANICS OF USE AND BENEFITS OF PLANNING WITH FLPs



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Benefits of family limited partnerships**
 - *Ability to leverage annual gift tax exclusion and lifetime giving exclusion by applying discounts for lack of control and lack of marketability*
 - *Retention of control over transferred assets*
 - Senior generation transferors are general partners who control the decision-making



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Exclusion Leverage Techniques**
 - *Two steps:*
 - Discounts at initial transfer
 - Post-transfer appreciation



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Advantages of family limited partnerships**
 - *Ease of amendment*
 - *Protection from creditors*
 - *Annual gift giving*
 - *Simplicity of ownership*



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Disadvantages of family limited partnerships**
 - *Cost (professional fees for attorneys, business valuers)*
 - *Loss of IRC Section 1014 basis step-up (possible higher income tax costs)*
 - *Investment company characterization*
 - *Integrity challenges*



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**
 - *Created by transferring assets to a newly-formed limited partnership*
 - Such contributions to capital, if done properly, can be accomplished without the imposition of tax on either the transferor or the transferee partnership
 - Generally, the most desirable properties to contribute to the limited partnership are those that will likely see significant appreciation over the planning period



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**
 - *Key consideration in selection of assets will be the value of the assets expected to be transferred*
 - Property commonly transferred includes real property, appreciating financial securities and oil and natural gas mineral rights
 - Appraisals and valuations must be obtained to determine the value of the assets to be transferred



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**
 - *Next step is creating a partnership agreement and registering the limited partnership*
 - Requires careful focus and attention of legal advisors
 - Valuation professionals may be consulted to review the partnership agreement to advise on how the provisions may affect the final valuation



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**
 - *A limited liability organization is often created to hold the general partner ownership interest*
 - Done to address concerns over the exposure of remaining senior generation family assets to general liabilities of the partnership
 - Limited liability companies serving as general partners in a family limited partnership are usually taxed as partnerships



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**

- *Funding the family limited partnership*

- Initial contribution accomplished by providing capital to the general partner entity in exchange for its capital ownership interests, and through the contribution of assets to the partnership for all of the limited partner ownership interests
- The general partner entity then contributes capital to the limited partnership in exchange for its general partner ownership interests



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**

- *Valuing the limited partner ownership interests*

- Includes discounts for lack of control, lack of marketability
- Valuation is performed in addition to other appraisals and valuations performed earlier in the process
- Conclusions of value set forth in this valuation will set the course for how many limited partner ownership interests will be transferred in accordance with the planning strategy developed by legal counsel



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MECHANICS AND BENEFITS OF PLANNING WITH FLPs

- **Mechanics of a family limited partnership**
 - *Final step in the process*
 - Prepare gift tax and state transfer tax returns (if necessary) to comply with tax authority filing requirements



Family Limited Partnerships

IRS BATTLEGROUND



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IRS BATTLEGROUND

- **IRS continues to challenge FLP use on numerous fronts**
 - *Historically focused on formation issues and propriety of discounts and levels at which they were applied*
 - *More recently attacks include more sophisticated IRC provisions, including Sec. 2036(a), Sec. 2701, Sec. 2703 and Sec. 2704*
- **Many of the court decisions are “bad facts” cases**



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IRS BATTLEGROUND

- **Discount challenges**
 - *Valuation issues different for general and limited partnership ownership interests*
 - Primary factor is control (or lack thereof)
 - Other general partner restrictions, such as redemption limitations, can affect discounts for lack of control and lack of marketability



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IRS BATTLEGROUND

- **Discount challenges**
 - *Assignee interests valued differently than limited and general interests*
 - Permitted assignee interests are worth less than limited partner interests due to greater transferability restrictions



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IRS BATTLEGROUND

- **Relevant cases involving IRS attacks on discounts**
 - *McCord*
 - *Lappo*
 - *Peracchio*
 - *Kelly*
 - *Astleford*



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IRS BATTLEGROUND

- **Internal Revenue Code – Chapter 14**
 - *Enacted in 1990 to circumvent and prevent “estate freeze” techniques*
 - *Assumption that senior generation who transferred property to junior generation will not exercise retained rights if inaction is advantageous to junior generation*
 - *IRC Section 2701-2704: “Special Valuation Rules”*



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IRS BATTLEGROUND

- **IRC Section 2701**
 - *Special valuation rules to determine the dollar value of a gift when an individual transfers an equity ownership interest in a partnership (or corporation) to a member of that individual’s family*
 - *Limits the gift value of any partnership interest when another interest might be retained by the transferor partner*



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IRS BATTLEGROUND

- **IRC Section 2702**
 - *Special valuation rules for transfers of interests in trusts*
 - *Not directly applicable to family limited partnerships*



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IRS BATTLEGROUND

- **IRC Section 2703**
 - *Provides that, for purposes of estate, gift and generation-skipping transfer tax, the value of property is determined without regard to any option, agreement or other restriction on the right to sell or use such property*
 - *Level of relief to general provision provided by 2703(b)*



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IRS BATTLEGROUND

- **IRC Section 2703(b) - exemptions**

- *IRC 2703 will not apply to any option, agreement, right or restriction that meets all three criteria below:*

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



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IRS BATTLEGROUND

- **IRS challenges under Section 2703**

- *Used regularly (often in conjunction with Sec. 2704) in attacks against family limited partnerships*

- TAM 9719006 (1997) and numerous other TAMs ruling on "sham transactions"
- *Strangi* – IRS arguments under 2703 dismissed by Court
- Private letter rulings also released on similar issues



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IRS BATTLEGROUND

- **IRC Section 2704**

- *2704(a) – certain lapsing restrictions of voting or liquidation rights in a partnership are treated as transfers subject to gift or estate tax, if transferor and members of the transferor family control the entity, both before and after, the lapse of that right*



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IRS BATTLEGROUND

- **IRC Section 2704**

- *2704(b) – if there is a transfer of an interest in a partnership to a member of the transferor’s family, and immediately after the transfer, the transferor and members of his or her family control the entity, any “applicable restriction” is disregarded in determining the value of the transferred interest*



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IRS BATTLEGROUND

- **IRS challenges under Section 2704**
 - *Issued numerous TAMs challenging validity of family limited partnerships, specifically in situations where:*
 - The transaction included a transfer of liquid assets to a limited partnership
 - The transferors were elderly and near the end of their lives
 - The transfers were carried out by third parties that were generally related (children) under a power of attorney



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IRS BATTLEGROUND

- **IRC Section 2036**
 - *IRC Section most often used by the IRS to challenge family limited partnerships*
 - *Any gift over which the transferor/donor retains for life, or for a period of time which does not end before his or her death, possession and enjoyment (control) over the gifted property, or has the right to designate who gets possession or enjoyment, will be disregarded under IRC section 2036(a), and that value will revert to his/her taxable estate*



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IRS BATTLEGROUNDS

- **IRS challenges under Section 2036**
 - *IRS has been reasonably successful in these challenges*
 - *Several relevant court cases, but most notably:*
 - *Schauerhamer (1997)*
 - *Jorgensen (2009)*



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IRS BATTLEGROUNDS

- **Conclusion**
 - *Careful efforts when forming family limited partnerships can mitigate risks*
 - *Understanding of IRC code and recent judicial decisions necessary to minimize IRS scrutiny and maximize benefits*



Family Limited Partnerships

VALUATION OF FAMILY LIMITED PARTNERSHIPS: APPROACHES



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VALUATION OF FLPs: APPROACHES

- **Types of assets contributed to family limited partnerships**
 - *Cash and cash equivalents*
 - *Marketable securities*
 - *Non-homestead real estate*
 - *Oil and gas properties*
 - *Buildings or equipment lease to an operating entity*
 - *Equity interests in privately-held businesses*



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VALUATION OF FLPs: APPROACHES

- **Standard of value – fair market value**
 - *Most common standard of value*
 - *Defined by Revenue Ruling 59-60:*
 - The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is under no compulsion to sell, both parties having reasonable knowledge of relevant facts



The Realities of Estate Planning with FLPs

VALUATION OF FLPs: APPROACHES

- **Standard of value**
 - *Rev. Rul. 59-60 definition of fair market value requires:*
 - Valuation result to be driven by a hypothetical sale
 - Value to be determined under prevalent economic and market conditions at a particular date of valuation
 - Reasonable time allowed for exposure in the open market
 - *Notes that proper determination of value will depend on the circumstances specific to each case*



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VALUATION OF FLPs: APPROACHES

- **Premise of value**
 - *Assumption regarding most likely set of transactional circumstances that may be applicable to the valuation*
 - Going concern
 - Liquidation (orderly or forced)



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VALUATION OF FLPs: APPROACHES

- **Date of valuation**
 - *Date or dates on which the subject entity will be valued is critically important because events and circumstances can arise that can cause value to vary materially from one date to another*
 - *Influences the information available for the valuation*
 - *Perspective from which all analysis is performed*



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VALUATION OF FLPs: APPROACHES

- **Date of valuation**
 - *A valuation is prepared “as of” the valuation date, and subsequent events and data are typically not considered*
 - *All information must be known or knowable to a potential purchaser of the subject interest as of the date of valuation*



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VALUATION OF FLPs: APPROACHES

- **Approaches to valuation**
 - *Many factors impact selection of approach used*
 - *Generally revolves around the quality of information available and the prospects for liquidation or continued operation*



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VALUATION OF FLPs: APPROACHES

▪ Approaches to valuation

– *Asset-based approach (Underlying Assets Methods)*

- Generally more suited to valuing controlling interests
- Should only be used to value minority interests if those interests can cause the company to sell its assets, or if the company is the type of company whose stock should normally be valued primarily on an asset basis
- Methods generally produce a control, marketable value



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VALUATION OF FLPs: APPROACHES

▪ Approaches to valuation

– *Asset approach*

- Primarily a function of modifying balance sheet assets and liabilities from historical “carrying” values to economic values at the date of valuation
- Valuator must have an understanding of the accounting principles that were used to prepare the subject entity’s financial statement



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VALUATION OF FLPs: APPROACHES

- **Approaches to valuation**

- *Asset approach*

- All assets and liabilities should be restated to current values using the appropriate standard of value, consistent with that used for the overall family limited partnership valuation
 - Valuator may rely on different sources for indicators of fair market value and/or consult other experts to determine the fair market value of certain assets, notably, tangible assets



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VALUATION OF FLPs: APPROACHES

- **Real estate appraisals**
- **Machinery and Equipment (M&E) appraisals**



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VALUATION OF FLPs: APPROACHES

- **Income approach**
 - *Used to determine value if entity structure includes an investment in an operating business*
 - *Based on the economic principle of anticipation*
 - *Determined by application of three primary methods:*
 - Capitalized cash flow method (CCF)
 - Discounted cash flow method (DCF)
 - Excess cash flow method (ECF)



Family Limited Partnerships

VALUATION OF FAMILY LIMITED PARTNERSHIPS: DISCOUNTS



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VALUATION OF FLPs: DISCOUNTS

- **Multi-level (tiered-entity) discounts**
 - *Tiered entity structure generally defined as holding companies that own an interest in another company or companies*
 - *Can discounts be applied to each entity within the structure?*
 - Top tier
 - Lower tier



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VALUATION OF FLPs: DISCOUNTS

- **Multi-level (tiered-entity) discounts**
 - *Applicable discounts for lack of control and marketability are first applied to lower tier then to top tier*
 - *IRS has historically challenged multi-level discounts as duplicative, but Courts have allowed multi-level valuation discounts in many cases*
 - *Application of discounts at each level requires critical analysis of facts and circumstances in each case*



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VALUATION OF FLPs: DISCOUNTS

- **Why discounts are applicable to FLPs**
 - *Rev. Rul. 59-60 “hypothetical buyer” would not purchase limited partner interest based solely upon value of assets*
 - Lack of management participation/Lack of control
 - Marketability issues



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VALUATION OF FLPs: DISCOUNTS

- **Discounts of lack of control**
 - *Determination of whether discount applies depends on the interest being valued and the valuation approach used*
 - *Several factors buyer considers before acquiring interest*
 - Management and voting rights
 - Restrictions on dispositions
 - Minimum distribution requirements
 - Partnership control



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VALUATION OF FLPs: DISCOUNTS

- Sources of lack of control discounts
 - *Compare control acquisition prices with pre-acquisition minority interest transaction prices*
 - *Implied minority discount is derived from inverse of control premium*
 - *Mergerstat[®] Review provides historical analysis of control premiums and corresponding minority discounts*



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VALUATION OF FLPs: DISCOUNTS

- Sources of lack of control discounts
 - *If entity holds marketable securities, discount can be quantified using data derived from closed-end funds*



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VALUATION OF FLPs: DISCOUNTS

- **Discounts of lack of marketability**

- *IRS Job Aid defines marketability*

- “The ability to quickly convert property to cash at minimal cost –

- “with a high degree of certainty of realizing the anticipated current proceeds”



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VALUATION OF FLPs: DISCOUNTS

- **Discounts of lack of marketability**

- *IRS Job Aid distinction between marketability and liquidity*

- Marketability: the fact of “salability”
 - Liquidity: how fast that sale can occur at the current price



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VALUATION OF FLPs: DISCOUNTS

- **Discounts of lack of marketability**
 - *Ability to liquidate an interest in a privately-held company does not exist at the same level as public-held equity*
 - *Investor is subject to substantially-higher risk, and the valuation of the interest must be adjusted accordingly with a discount for lack of marketability*



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VALUATION OF FLPs: DISCOUNTS

- **Sources of lack of marketability discounts**
 - *Four broad categories:*
 - Benchmark studies
 - Securities-based approaches
 - Analytical approaches
 - Other approaches
 - *Valuators must drill down into empirical studies and/or employ other quantitative methods to determine discount*



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VALUATION OF FLPs: DISCOUNTS

- Sources of lack of marketability discounts
 - *Benchmark studies*
 - Restricted stock studies
 - Pre-IPO studies



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VALUATION OF FLPs: DISCOUNTS

- Sources of lack of marketability discounts
 - *Restricted stock studies*
 - SEC Institutional Investors
 - Hall & Polacek
 - Trout
 - Johnson
 - Stryker/Pittcock
 - Columbia Financial Advisors
 - Silber
 - FMV Opinions



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VALUATION OF FLPs: DISCOUNTS

- Sources of lack of marketability discounts

- *Pre-IPO studies*

- Emory & Dot-com
- Hitchner
- Willamette Management
- Valuation Advisors



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VALUATION OF FLPs: DISCOUNTS

- Sources of lack of marketability discounts

- *Mandelbaum factors*

- Financial statement issues
- Dividend policies
- Company history/position and economic outlook
- Management characteristics



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VALUATION OF FLPs: DISCOUNTS

- **Sources of lack of marketability discounts**
 - *Mandelbaum factors*
 - Control inherent in transferred shares
 - Transfer restrictions
 - Holding period
 - Redemption period
 - Costs associated with a public offering



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VALUATION OF FLPs: DISCOUNTS

- **Sources of lack of marketability discounts**
 - *Securities-based approaches*
 - Based on option pricing models and observing illiquidity of stock prices
 - Not widely-used in valuation of closely-held businesses



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VALUATION OF FLPs: DISCOUNTS

▪ Sources of lack of marketability discounts

– *Analytical approaches*

- Studies that investigate circumstances and results of “bulk” private placement of unregistered and/or registered stock
- Compare total discount per share for the private placement of unregistered shares to that of registered shares
- Prepared primarily by members of academia
- Not vetted by the court or widely-accepted by valuers



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VALUATION OF FLPs: DISCOUNTS

▪ Sources of lack of marketability discounts

– *Other approaches*

- QMDM – Mercer
- NICE – Frazier
- CAPM – Tabak
- Partnership Profiles



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VALUATION OF FLPs: DISCOUNTS

- **Sources of lack of marketability discounts**
 - *Partnership Profiles database*
 - Summarizes transactions of ownership interests in limited partnerships that are publicly traded on a secondary market
 - For discount data to be relevant, interest being valued must be non-controlling and have marketability issues



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VALUATION OF FLPs: DISCOUNTS

- **Sources of lack of marketability discounts**
 - *Partnership Profiles 2011 Discount Study*
 - Partnerships in study placed in four categories
 - Additional refinements can further narrow comparable data



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VALUATION OF FLPs: DISCOUNTS

- **Other discounts**
 - *Many other types of discounts can be applicable to family limited partnerships*
 - Avoid double-counting
 - *Key to successfully applying discounts is to have clear understanding of the bundle of rights attendant to the subject interest*



Family Limited Partnerships

WORKING EXAMPLE: FAMILY LIMITED PARTNERSHIP VALUATION



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WORKING EXAMPLE: VALUATION OF A FLP

- **Background**
 - *Valuation prepared to render an opinion as to the fair market value of a 1% limited partner interest in a family limited partnership for estate planning purposes*
 - *Valuation date is September 30, 2011*



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WORKING EXAMPLE: VALUATION OF A FLP

- **Background**
 - *ABC Family Partners, L.P. formed on July 1, 2009*
 - *Primary business purpose of the Partnership is to buy, sell, lease, option, rent, operate, mortgage, encumber, own and in any other manner deal with or in property, real or personal, tangible or intangible*



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WORKING EXAMPLE: VALUATION OF A FLP

■ Background

– *Rights of general partner*

- General partner no personally liable for return of capital contributions of limited partners
- General partner may not assign or transfer his interest without written consent of all partners



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WORKING EXAMPLE: VALUATION OF A FLP

■ Background

– *Rights of limited partners*

- No authority to act on behalf of the Partnership
- No rights in connection with management of the Partnership
- May not take part in conduct or control of Partnership's business and/or assets
- Limited partner interest not assignable without written consent of general partner and majority of limited partners



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WORKING EXAMPLE: VALUATION OF A FLP

■ Background

– *Successors and removal*

- Any Partner may designate a successor of interest to take effect upon the death or termination of such Partner (general partner requires written consent of all the Partners)
- A limited partner may be removed at any time by affirmative vote of general partner and majority of limited partners.
- A general partner may never be removed



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WORKING EXAMPLE: VALUATION OF A FLP

■ Background

– *Dissolution*

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



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WORKING EXAMPLE: VALUATION OF A FLP

■ Background

– *Dissolution*

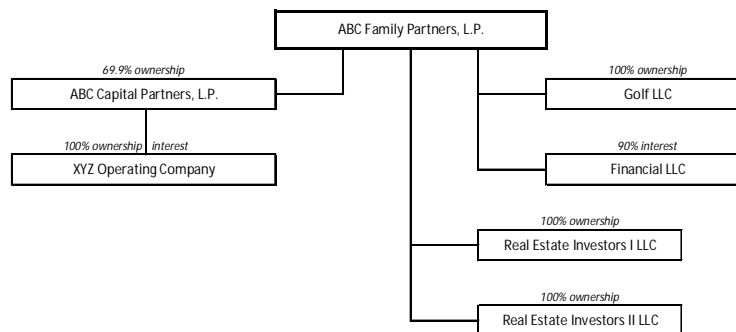
- Partnership may be dissolved upon: expiration of the term of the Partnership; agreement of all Partners to dissolve; failure to continue the Partnership following a Partner's withdrawal or removal; or the bankruptcy, withdrawal or death of all of the general partners, unless all remaining Partners agree to accept a designated successor as a general partner or elect one or more general partners within 180 days following the occurrence of the event causing the dissolution



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WORKING EXAMPLE: VALUATION OF A FLP

■ ABC FLP Organization Structure





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WORKING EXAMPLE: VALUATION OF A FLP

- **Description and value of underlying assets**
 - *ABC Family Partners L.P. is a holding company with multiple subsidiaries that generate revenue through rental and operations*
 - *At date of valuation, partnerships assets include cash, marketable securities and investments in subsidiaries*



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WORKING EXAMPLE: VALUATION OF A FLP

- **Description and value of underlying assets**
 - *Cash and cash equivalents = \$10,000*
 - *Investments in marketable securities = \$50,000,000*



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WORKING EXAMPLE: VALUATION OF A FLP

▪ Description and value of underlying assets

– *Investments in Subsidiaries:*

- Wholly-owned:
 - Investors I = \$ 15,000,000
 - Investors II = \$ 20,000,000
 - Golf LLC = \$ 5,000,000
- Partially-owned:
 - Financial LLC = \$ 1,000,000
 - ABC Capital = \$ 14,000,000



The Realities of Estate Planning with FLPs

WORKING EXAMPLE: VALUATION OF A FLP

▪ Description and value of underlying assets

– *Multi-level discounts*

- No adjustment for lack of control – ABC FLP holds controlling interests in the subsidiaries
- 10% discount applied to value of each subsidiary at lower-tier level



The Realities of Estate Planning with FLPs

WORKING EXAMPLE: VALUATION OF A FLP

- **Cost/asset approach**
 - *Determine value of assets (\$99,510,000) minus liabilities (\$25,000) provides net asset value (\$74,510,000)*
 - Pro-rata value of 1% L.P. interest = \$745,100
 - *Discounts for lack of control and lack of marketability applied by asset type or class*



The Realities of Estate Planning with FLPs

WORKING EXAMPLE: VALUATION OF A FLP

- **Cost/asset approach**
 - *Discounts applied by asset type or class*
 - No discount applied to cash held by partnership
 - Lack of control discounts:
 - Mergerstat Review used for ABC Capital & Financial LLC (20% each) and Golf LLC (25%)
 - Morningstar Closed-end fund analysis used for marketable securities (6%)



The Realities of Estate Planning with FLPs

WORKING EXAMPLE: VALUATION OF A FLP

- **Cost/asset approach**
 - *Discounts applied by asset type or class*
 - Lack of marketability:
 - FMV Restricted Stock study database used to determine discount of 16%
 - Combined discounts:
 - Partnership profiles used to determine combined discount (17%) for real estate: Investors I and Investors II



The Realities of Estate Planning with FLPs

WORKING EXAMPLE: VALUATION OF A FLP

<i>Asset</i>	<i>Discount for Lack of</i>		<i>Combined</i>	<i>Weight</i>	<i>Weighted Discount</i>
	<i>Control</i>	<i>Marketability</i>			
Cash	0%	0%	0%	0.01%	0.00%
Investments in:					
Marketable Securities	6%	16%	21%	50.25%	10.55%
Real Estate	*	*	17%	31.66%	5.39%
ABC Capital Partners, LP	20%	16%	33%	12.66%	4.18%
Financial LLC	20%	16%	33%	0.90%	0.30%
Golf LLC	25%	16%	37%	4.52%	1.67%
Total					<u>22.09%</u>
Rounded					<u>22.00%</u>

** Partnership Profiles database produces a combined discount*



The Realities of Estate Planning with FLPs

WORKING EXAMPLE: VALUATION OF A FLP

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



Family Limited Partnerships

RECENT COURT CASES RELATING TO FLPs



The Realities of Estate Planning with FLPs

RECENT COURT CASES RELATING TO FLPs

- **Tiered-entity and Miscellaneous Discounts**
 - *Astleford v. Commissioner*
 - *Keller v. United States*
 - *Dawkins v. Hickman Family Corp.*
 - *Murphy v. United States*



The Realities of Estate Planning with FLPs

RECENT COURT CASES RELATING TO FLPs

- **Section 2036 Issues**
 - *Gaiimo v. Vitale*
 - *Estate of Black v. Commissioner*
 - *Estate of Turner v. Commissioner*
 - *Estate of Schurtz v. Commissioner*
 - *Estate of Liljestrands v. Commissioner*
 - *Holman v. Commissioner*



The Realities of Estate Planning with FLPs

RECENT COURT CASES RELATING TO FLPs

- **Valuation Methods**
 - *Estate of Giustina v. Commissioner*



Family Limited Partnerships

CONCLUSION AND PRACTICAL CONSIDERATIONS



The Realities of Estate Planning with FLPs

CONCLUSION AND PRACTICAL CONSIDERATIONS

- **Though complex, with proper planning and design, family limited partnerships offer an excellent means for privately-held businesses to centralize control, limit liability and protect assets of family members**
- **Proper steps should be taken early in the formation process to protect against potential IRS challenge**
 - *Design and implementation should be a “team effort” between legal counsel and a business valuator*



Family Limited Partnerships

THANK YOU!