



Planning with Family Limited Partnerships (FLPs) & Limited Liability Companies (LLCs)

Presentation by

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Overview

- ◆ Discount Comfort Zone
 - Empire
 - IRS
 - Quantification
- ◆ Tax Court Case Review
- ◆ Private Negotiation Results

Quantification of Discounts

- ◆ Important to segregate Minority Interest Discount (MID) and Discount for Lack of Marketability (DLOM)
- ◆ Discounts are “inverse multiplicative,” not additive
 - $(1 - \text{MID}) \times (1 - \text{DLOM}) = (1 - \text{Total Discount})$
- ◆ Sources of Discounts
 - Closed-end funds and secondary market LP transactions provide data on discounts from net asset values (NAV)
 - Hall & Polacek (Estate Planning, Jan/Feb 1994)
 - Valuation Advisors LOMD IPO Study (BVU, July 2004)
 - FMV Opinions Restricted Stock Study (BVU, Sep 2003)
 - Hertzell & Smith (Journal of Finance, June 1993)
 - Numerous restricted stock & IPO studies (“the usual suspects”)

Quantification of Discounts

- ◆ Additional Considerations for Quantifying the MID & DLOM
 - Underlying assets matter
 - Marketable securities
 - Real estate (developed, undeveloped)
 - Operating business
 - Diversified v non-diversified portfolio in LLP/LLC
 - Distributing v non-distributing assets/entity
 - Current return beyond simple distribution of taxes due reduces discount (other things equal)

Valuation Issues

- ◆ Estate of Webster E. Kelley v Commissioner, TC Memo 2005-235, October 11, 2005
 - Decedent owned 33.3% interest in KLBP LLC and 94.83% interest in KLLP (underlying assets are cash & CD's)
 - KLBP LLC owned a 1% interest in KLLP (KLBP LLC's only asset)
 - Decedent expert submits report for 53.5% all-in discount
 - 25% MID based upon lowest quartile closed-end funds
 - 38% DLOM based upon standard restricted stock studies and LP agreement limitations on transfer
 - IRS allows for 25.2% discount
 - 12% MID based upon all comparable closed end funds
 - IRS suggests 15% discount based upon study by Dr. Bajaj and low risk associated with LP's portfolio holdings

Valuation Issues

- ◆ Estate of Webster E. Kelley v Commissioner
 - Tax Court cites 2% MID based upon *Peraccio* for Cash & Mkt Sec's, but accepts IRS at 12%
 - Tax Court cites *McCord* (120 TC 394-395) modifications to Bajaj data, ie, a 20% DLOM, adds 3% for specific limited marketability of LP interests and concludes DLOM of 23%
 - Tax Court provides no additional discount for KLBP LLC interest in KLLP

Valuation Issues

- ◆ Albert Strangi v Commissioner, No. 03-60992, US Court of Appeals (5th Circuit), July 15, 2005
 - Mr. Strangi enjoyed benefit of residential property subsequent to transfer to the FLP, effectively rent-free
 - Mr. Strangi had few assets outside of the FLP
 - Mr. Strangi depended upon distributions from the FLP to meet living expenses
 - Court found “no bona fide sale” of assets to the FLP
 - Bona fide sale means the transfer must serve a “substantial business or other non-tax purpose”
 - Conclusion:
 - Mr. Strangi did not give up possession of the assets even after transferring them to the FLP
 - The assets transferred to the FLP are brought back into the estate and subject to estate tax

Valuation Issues

- ◆ Estate of Jelke, TCM 2005-131, May 31, 2005
 - Decedent owned 6% interest in holding company (C corp.)
 - Holdings consisted primarily of large, well-known “blue chip” public companies
 - Portfolio was managed by experienced outside management group
 - 10% Discount for Lack of Control
 - Court say strong historical returns implies lower discount and less demand for control; look at the way an investor in mutual funds would look at it
 - 15% Discount for Lack of Marketability
 - Lower than typical LOMD attributable to diversified holdings of marketable securities, history of long term appreciation, no restrictions on share transferability and acceptance of a BICG (C Corp, however)
 - Tax Court not satisfied with taxpayer’s proposed 35% discount based upon standard restricted stock studies

Valuation Issues

- ◆ Santa Monica Pictures v Commissioner, TCM 2005-105, May 11, 2005
 - Expert Witness “Survivor”
 - Three experts at trial – only one survived
 - Big Four CPA with 20 years of experience
 - Ph. D. in Economics; Professor in US & Overseas; Author; Prior expert testimony
 - Entertainment attorney
 - The Taxpayer is not laughing

Valuation Issues

- ◆ Estate of Bigelow, TCM 2005-65, March 30, 2005
 - FLP formed to hold real property of Decedent's trust
 - Post-transfer, Decedent left with insufficient income to meet her living expenses or property debt service
 - Decedent's sole purpose in establishing the FLP was to reduce estate tax
 - Taxpayer loses: Real property includable in Decedent's gross estate under 2036

Valuation Issues

- ◆ Estate of Bongard, 124 TC No. 8, March 15, 2005
 - Empac stock to WCB Holdings, LLC: OK
 - Better position for corporate liquidity event
 - Enhance ability to raise capital and govern the company
 - TC holds bona fide sale (“legitimate and significant non-tax reason for the transfer”)
 - Form Bongard FLP to hold WCB Holdings Class B member interests
 - Gift of 7.72% Bongard FLP LP interest
 - Transfer of Class B member interests to Bongard FLP did not satisfy bona fide sale exception under 2036: includable in gross estate

Valuation Issues

- ◆ Estate of Noble, TCM 2005-2, January 6, 2005
 - Estate values 11.6% interest in Glenwood State Bank (“GSB”) at \$904k (BV less 45% MID)
 - GSB is a small, privately-held bank in rural Iowa (\$81mm in assets; low ROE; minimal growth prospects)
 - Judge Laro rejects expert reports of Taxpayer and IRS
 - Judge concludes value based upon transaction 14 months after the DOD (shares were sold for \$1,100k to the parent company and owner of the remaining 88.4% interest), less 3% inflation, or \$1,067k
 - Valuation camp not happy
 - Issue of theory, not practical result
 - Transaction premium?
 - Trend in bank values over the 14-month period?
 - Facts of case; ROE

Valuation Issues

- ◆ Estate of Mildred Green, TC Memo 2003-348, December 29, 2003
 - Decedent held 5% of a St. Louis, MO bank (assets \$173mm, SHE \$17mm)
 - Nov 1998, Estate values stock at \$164,000
 - IRS claims value of \$1,048,000
 - At trial, Estate @ \$655k (\$200ps), IRS @ \$860k (\$263ps)
 - Minority interest discounts: Estate 17%, IRS 15%
 - Interesting, because 2 of 3 valuation approaches (income & guideline co. vs. transactions) are not Control
 - Estate expert relied on generic Mergerstat premiums, with no explanation – Court hates this

Valuation Issues

- ◆ Estate of Mildred Green, December 29, 2003
 - IRS relied on Midwest bank transaction premiums, but their own data showed a discount range of 18.4% - 19.6%!
 - Court unhappy with both experts, chooses 17% MID
- LOM Discount: Estate 40%, IRS 25%
 - Estate: restricted stock studies 35%, pre-IPO studies 44%
 - Estate also looked at 7 prior transactions, 6 more than 3 years old
 - No indication if arms length
 - No viable benchmark for comparison (ie, contemporaneous values)
 - IRS cites restricted stock studies at 30% - 35%, as well as Hall/Polacek (1994) study – average discount: 23%
 - Court notes that H/P study actually reflects 30% - 40% for small companies like subject bank! – concludes 35% based upon size

Valuation Issues

- ◆ Peracchio v Commissioner, TCM 2003-280, September 25, 2003
 - TP forms FLP with \$2mm of cash & mktable securities
 - TP claims discount of 40% for LOM & MI, combined
 - IRS Position One
 - Disregard FLP: no economic substance [dropped]
 - Standard restrictions on transfer violate Sect. 2703(a)(2) [dropped]
 - Restriction on ability to withdraw is an applicable restriction under Sect. 2704(b) to be disregarded [dropped]
 - FMV of transferred interests should recognize no discounts
 - IRS Revised Position: 4.4% MID, 15% DLOM
 - Court favorably cites McCord (2003): treat like closed end fund

Valuation Issues

Peracchio : Methodology used for determining minority interest discount was NAV approach with “stratifying” of assets; Court concludes 6% MID/ICD

	<u>% of NAV</u>	<u>Discount</u>	<u>Weighted Discount</u>
Cash & Funds	44.0%	2.0%	0.9%
U.S. Gov't	0.4%	6.9%	0.0%
Muni's	7.1%	3.5%	0.2%
Dom.	43.6%	9.6%	4.2%
For. Equities	4.9%	13.8%	0.7%
	<u>100.0%</u>		<u>6.0%</u>

Lack of Marketability: TP & IRS both cite Mandelbaum (1996); Court says no connection to FLP & Mandelbaum is not a legal standard; TP cites restricted stock studies of private placements for 30%, add 10% to reach 40%, but provides no support for +10% or application to FLP; IRS cites range of 5% - 25% & chooses midpoint of 15%; again no basis; Tax Court selects 25% as IRS upper bound.

Valuation Issues

- ◆ Lappo v Commissioner, TCM 2003-258, September 3, 2003
 - FLP consisting of muni bonds (\$1.3mm) and lumberyards (\$1.9mm) leased to Wickes Lumber (15-yr lease)
 - IRS withdrew “economic substance” and Section 2703(a)(2) contentions from Notice of Deficiency
 - Muni Bond Minority Interest Discount
 - TP says 8.5%, IRS 7.5%; Court accepts 8.5%
 - Real Estate Minority Interest Discount
 - TP Expert concludes 30-35% based upon a sample of 7 (out of 400!) REITs & REOCs; Court says sample too small and skewed to maximize discount; “adjusted” raw data revealed discounts of 20-29%; removing 4 REITs that the Court didn’t like resulted in discount range of only 0-5%!

Valuation Issues

- ◆ Lappo v Commissioner, September 3, 2003
 - Real Estate Minority Interest Discount
 - IRS Expert selects 52 REITs out of sample of 62 that comprised 80% of total public REIT market capitalization
 - Court prefers IRS Expert approach conceptually, but alters it dramatically and concludes 19% MID on the Real Estate
 - Marketability Discount
 - TP Expert selects 39 private placement transactions (in restricted stock in public companies) as “guideline” out of 197 transactions
 - Median discount among the 39 was 29%; Expert proposes 35%
 - Court notes that if eliminate the 13 high tech companies from the 39, median discount is 19%
 - IRS Expert cites Bajaj study to support 7.2% DLOM
 - Court notes that avg discount in Bajaj study is 22.2% (raw data); a Hertzell & Smith study reported an avg private placement discount of 20%
 - Court takes avg of 21% and adds 3% to account for FLP specifics: 24%

Introduction to Empire Valuation Consultants

- ◆ One of largest East Coast independent valuation firms
- ◆ Started 1988
 - Originated as “Chase Manhattan Valuation Consultants” in 1982
- ◆ Offices in New York City, Rochester, West Hartford and Atlanta
- ◆ Senior staff has more than 100 years of valuation experience



Empire's People

- ◆ Over 50 highly trained professionals
 - MBAs
 - Credentials (CFA, ASA, CPA, CBA, ABV)
 - National recognition as:
 - Chairman of Board of Examiners of ASA
 - Valuation Committee of ASA
 - Valuation Subcommittee of ESOP Association
 - Various Committees of the NYSSCPA, AICPA & NYSSA

- ◆ 8 Support Staff
 - Research Assistants & clerical

Empire's People (cont'd)

- ◆ Senior staff members have qualified as valuation experts in several jurisdictions:
 - U.S. Tax Court
 - U.S. Bankruptcy Court
 - N.Y. Supreme Court (Several throughout State)
 - N.Y. Surrogates Court (Several throughout State)
 - State Jurisdictions including California, Connecticut, Georgia, New Hampshire, New Jersey, Tennessee, Virginia
 - American Arbitration Association



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Mark Shayne is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers and Accredited in Business Valuation (ABV) by the American Institute of Certified Public Accountants. Mr. Shayne is a Managing Director with Empire Valuation Consultants, LLC.

Mr. Shayne has over 20 years of experience providing financial consulting, appraisal, due diligence, and expert witness testimony on valuation matters. Mr. Shayne holds a Bachelor of Science degree from The Wharton School, University of Pennsylvania, and earned an MBA degree with Distinction from the Stern Graduate School of Business at New York University.

Mr. Shayne has testified as an expert witness in Federal and State Courts and before the American Arbitration Association. He has lectured on business valuation, the valuation of intellectual property, estate & gift tax valuation issues, and SFAS 141 and 142 in front of accounting, appraisal, legal and technology organizations. He is a Professor of Finance (Business Valuation) at Fordham University's Graduate School of Business. Mr. Shayne is a past President of the NYC chapter of the American Society of Appraisers and past Chair of the *Investing in Israel High Technology Conference* sponsored by the New York Society of Security Analysts.