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FAIR VALUE™

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# Family Limited Partnerships Holding Marketable Securities

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**Introduction.** In the September, 1994, issue of *Fair Value*, we examined the discounts associated with family limited partnerships holding real estate. In that article, we developed and explored potential comparable entities to use as a benchmark in analyzing and valuing the closely-held partnership interests at issue. Real estate, however, is only one of the two major asset classes being used in family limited partnerships. What about publicly-traded stocks and bonds? How does one develop an appropriate discount for a minority interest in these assets? This article will examine the valuation theory and techniques available to determine if minority discounts in particular are applicable and, if so, how large they should be. The point of this article is to stress the importance of a well-documented and fully supportable appraisal. The use of "standard" discounts without adequate support can lead to embarrassing or financially painful experiences with the IRS.


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**A Word of Clarification.** This article deals strictly with the discount associated with a minority interest, not with the discount associated with a lack of marketability. The benchmarks discussed in this article are very small minority interests in completely liquid companies. This is in sharp contrast to the average family limited partnership where a limited partner may be severely restricted in his ability to sell or transfer his LP unit and may have little or no hope that a market for his LP unit will ever exist. This article deals only with the comparability of a family LP to its market counterparts <u>before</u> any concerns about marketability are considered.

**Closed-End Mutual Funds.** In considering a market comparable to our family LP holding publicly-traded stocks and bonds, one possibility exists with the wide array of closed-end mutual funds. There are literally hundreds of closed-end mutual funds that offer numerous specialized investment options. Prices paid for publicly-traded shares in a closed-end fund represent minority interests in fully marketable securities. Therefore, if the net asset value (NAV) of a closed-end fund can be found and compared with the freely-traded price of the fund, it can be determined when and under what conditions the market affords a discount (or a premium) to the NAV of a minority interest.

**Anatomy of a Closed-end Fund.** A closed-end mutual fund issues a fixed number of shares that does not change over the life of the fund. Investors wishing to own shares in the fund must buy those shares from other closed-end fund shareholders, not the fund itself. This is in contrast to the more common open-end mutual fund where shares are bought and redeemed directly from or to the fund itself. When the demand for an open-end fund increases, the fund simply issues more shares. By contrast, when the demand for a closed-end fund increases, the price of shares in the fund increases. One significant difference between these two types of funds as affects value is the discount from the NAV of the fund.

**Net Asset Value.** The NAV of a closed-end or open-end mutual fund is the total value of all the stocks or bonds currently owned in the fund. In an open-end fund, share purchases and redemptions are generally priced at the

NAV of the fund (less any transaction costs). By contrast, the buying and selling of shares in a closed-end mutual fund takes place at the current market price of the fund. The current market price of a closed-end fund may be equal to the NAV, however, it may also be at a premium or a discount.

**Small Investor Sentiment.** In their article "Closed-end fund discounts" (Winter 1992 edition of *The Journal of Portfolio Management*), J. Bradford De Long and Andrei Shleifer argue that the existence and degree of a discount or premium is directly related to small investor sentiment. De Long and Shleifer argue that, because the capitalization of closed-end funds is relatively small, it is difficult for institutional investors to take a significant position in the fund and drive its market price back to its NAV (where it logically should be). Therefore, De Long and Shleifer believe that discounts or premia in closed-end funds are largely a reflection of the mood of individual investors.

**Why a Premium?** De Long and Shleifer believe that the single largest factor that explains a premium in a fund is the novelty of such a fund. De Long and Shleifer point to the initial emergence of closed-end funds in the 1920s and the substantial premiums to NAV (sometimes as much as 200%) associated with the new funds. Likewise, when the new "country funds" (such as the Thai Fund or the Germany Fund) first appeared in the late 1980s, they too traded at premiums ranging from 50% to 200%. Although the existence of a premium may be explained by hype or management "expertise" in a particular fund, in general, it makes little sense to pay more than a dollar for a dollar's worth of assets. Indeed, in today's markets, it is unusual to see a closed-end fund trade at a premium to NAV. Some notable exceptions include new issue funds (which trade at a premium briefly after their issue) or funds managed by a known "superstar" such as Mario Gabelli or Martin Zweig.

**Why a Discount?** There are numerous theories as to why closed-end funds trade at a discount to NAV. One theory states that funds sell at a discount because investors are taking future management fees and future changes in the management of the fund into account. Another theory argues that the discount is effectively a discount for lack of marketability for those funds holding large blocks of illiquid stocks. A third theory says that discounts may be a result of periodic oversupply of new closed-end funds in the market.

**Built-in Capital Gains.** The most interesting theory in trying to explain discounts to NAV is that investors are taking into account the built-in capital gains in the stocks held in the closed-end portfolio. This theory is not limited to marketable securities as it could apply to any asset with a potential capital gain (such as real estate). The IRS currently holds (in TAM 9150001) that, for valuation purposes, the effect of built-in capital gains cannot be considered in determining value. The IRS bases this holding on the rationale that (1) the capital gains liability is too speculative unless the liquidation of the fund is contemplated, and (2) a hypothetical buyer of the fund may not necessarily liquidate the fund and realize the gain. In his article in the June, 1993, edition of *Business Valuation Review*, John Gasiorowski argues forcefully that the IRS position does not make economic sense. Mr. Gasiorowski implies (correctly, we think) that, all else being equal, the rational buyer would pay less for a stock portfolio with a capital gains liability than the exact same portfolio with no capital gains liability.

**Chinks in the Armor.** Although the IRS has not formally changed its position, there are glimmers of hope that its current stand on built-in capital gains may not be etched in stone. In the *Kett* case, the attorney for the estate essentially argued that, "under the willing seller - willing buyer standard of value, the tax liability should be treated as a problem of the seller that a willing buyer is not going to pay for." Although the *Kett* facts involved C Corporations holding income-producing real estate, the same rationale could be argued for marketable securities. Using this rationale, the attorney for the estate was able to reach a settlement with the IRS (the case never went to trial) on a value based on a 40% discount from NAV. It is unclear from the settlement if the 40% discount was solely a result of the capital gains effect or if it also included a discount for lack of marketability. The estate's attorney credited his success to early and thorough estate planning, noting that "the tax advisor, whether tax attorney or CPA, would be well advised to address valuation issues in partnership with qualified business valuation appraisers at the stage of developing the plan for transferring wealth within the family."

**Guidance from the Courts.** We have considered the IRS' position on one facet that relates to the use of closed-end funds as comparables, however, what have the courts said about the treatment of built-in capital gains? As usual, the courts have provided ammunition for both positions. Cases such as *Gallun* (33 T.C.M. 1316, 1974), *Piper* (72 T.C. 1062, 1979) and *Andrews* (79 T.C. 938, 1982) agree with the current IRS position that capital gains should not be considered in the valuation. However, in a North Carolina federal case, *Clark* (75-1 USTC p 13,076, E.D.N.C. 1975), the court takes the opposite position to the later-passed IRS position on built-in capital gains. In *Clark*, the court stated that a willing purchaser would have discounted an investment portfolio from its NAV for several reasons, including the fact that the investment portfolio represented a trapped-in capital gains liability. Similarly, in *Obermer* (238 F.Supp. 29, 1964), the court acknowledged that built-in capital gains would adversely affect the value of a company to a mythical willing buyer.

**Valuing your Family Limited Partnership.** So how does all this translate to your family LP holding marketable securities? Should you apply a market discount or premium and, if so, how large or small should it be? The first step in answering these questions is to determine the asset composition of your family LP and then find suitable comparable funds in the market. In our experience at Banister Financial, most of the family LPs we have seen hold a portfolio of medium- to large-cap stocks. Therefore, for simplicity's sake, we will use closed-end funds holding equity securities as a proxy. As may be expected, there is a wide range of equity funds available to use, including funds by country, by industry sector, by market capitalization, etc. Likewise, there are bond funds segregated by government issues, corporate debt, high-yield, etc.

**Discounts by Market Capitalization of Stocks Held.** A specific sampling of certain closed-end funds holding large cap stocks shows a range from a 25.9% discount to NAV to a 17.7% premium to NAV over the 1982 to 1993 time frame. Likewise, a sampling of certain closed-end funds holding small cap stocks shows a range from a 29.8% discount to a 7.1% premium over the 1986 to 1993 time frame. It is conceivable that there are other funds whose performance falls outside of these ranges. The moral of the story: it is important to make sure that your valuation expert is using a fund whose composition closely resembles that of your fund.

**Discounts Over Time.** Just as discounts can vary widely from fund to fund, so can the discount vary widely over time. For example, one long-term growth fund with a current portfolio slightly over $100 million, traded at an average discount of 23.1% in 1982 but at an average premium of 7.2% just three years later. Indeed, the financial press in *Business Week* and *Forbes* has commented recently on the "bargains" that exist in closed-end funds at the current time. Both articles note that closed-end fund discounts generally widen in a bear market and narrow in a bull market, however, for whatever reason, discounts from NAV in closed-end funds have actually widened during the strong bull market of 1995.

**Marketability Discounts.** Remember that all this article has dealt with is the discount for a minority interest. In addition to this discount, it may also be appropriate to take an additional discount for the lack of marketability associated with the family LP holding marketable securities. Depending on the restrictions and limitations governing your family LP and the overall circumstances surrounding the ownership, this discount can range from 0% to 30% and higher. The application of a marketability discount is too complex a subject to be covered in this article and a decision on your individual family LP can only be reached after a thorough analysis of the partnership agreement, the ownership distribution, market data, applicable statutory provisions (including Chapter 14), relevant case law, and numerous other factors.

**Conclusion.** Hopefully, this article has provided a brief insight to the theory and workings of the application of a discount for minority interest for a family LP holding marketable securities. It is important to stress that only through a thorough and complete analysis of the specific LP can a reasonable and supportable discount be applied. The application of "standard" discounts that are not based on current market conditions or the portfolio mix in the family LP can be very dangerous in that they may be unsupportable when the time comes to defend them before the IRS.

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