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FAIR VALUE™

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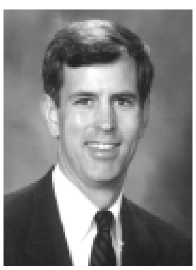
Are Minority and Marketability Discounts Always Appropriate in Family Limited Partnerships?

By: George B. Hawkins, ASA, CFA

Just Give me the "Standard" Discounts Please. *"I'll just take this nice shopping center, worth $5,000,000, put it in a family limited partnership, and then I will gift a 10% limited partnership interest to my daughter. It's a great deal because my attorney told me I could take the standard 28% discount for minority interest and the 35% discount for lack of marketability, and, presto, make the value for gift tax purposes not $500,000 (10% of $5 million), but $234,000 instead ($500,000 less the 28% and 35% discounts). We don't need a valuation because he told me these discounts always apply, regardless of the type of asset in the partnership, so why spend the money. Maybe next year I'll do the same thing with all of those publicly traded stocks and bonds I own."*



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Dangerous Thinking Indeed. But are such discounts always appropriate? No. While certain circumstances can warrant large discounts, this is by no means always true. A major misconception is being created on the estate planning lecture circuit; namely, that sizeable discounts are always appropriate, regardless of the type or investment attributes of the partnership or its underlying assets. Relying on an arbitrary selection of discounts when none may be appropriate could expose the client to substantial tax problems as a result. This article will address some of the factors that can influence the appropriateness and size of discounts and why only a thorough business valuation can uncover if discounts are indeed warranted and, if so, provide independent and unbiased support.

Why the Interest in Family Limited Partnerships. Revenue Ruling 93-12, in which the IRS gave up on its prior position on family attribution, created great interest by attorneys in helping their clients create family limited partnerships. "Family attribution" was a position that held that just because a security was a minority interest, it was not entitled to be valued as such when all of the holders were family members, under the theory that nobody was at a disadvantage, as the family votes as a unit. The reversal of the position made it more likely that minority and marketability discounts would go unchallenged in family ownership estate planning.

This reversal led to a surge in the creation of family limited partnerships. Typically, assets such as real estate or marketable securities are transferred into a newly created limited partnership. The parents, serving as general partners, then gift limited partnership interests to their children. The driving force behind this structure is the belief that the limited partnership interests can be gifted on a discounted basis from the holder's pro-rata share of the underlying appraised value of the partnership's assets, reflecting discounts for the minority (non-controlling) status of the limited partner interest, as well as its greater lack of marketability.

While discounts for minority status and lack of marketability are nothing new, their use in so called "family limited partnerships" is, with little guidance as to IRS position on their use.

Why Discounts Arise. The concept of minority and marketability discounts is well understood in the valuation of shares in operating companies. Namely, a minority shareholder may, depending on the facts and circumstances, have little or no ability to realize the fruits of a company's success, whether via the payment of dividends, the sale or liquidation of the Company or its assets. Because privately-held shares are not registered for public sale, and owing to little or no control, this also serves to limit marketability, hence, a discount for lack of marketability. In some companies, minority shareholders have a long history of being paid strong and consistent returns, whereas in others the returns are limited to nil. Therefore, the minority and marketability discounts can be impacted by each circumstance.

Importance to Family Limited Partnerships. What is the relevance of this to small limited partnership interests? First, just because the interest has no control does not mean that all such interests are created equal at valuation time. The business appraiser must examine the specifics of the interest, the partnership, its performance, the degree its performance is returned to its holders in the form of distributions and other factors which impact the appropriateness of discounts, if at all, and if so, the relevant size.

While we would agree that the discounts for minority interest and lack of marketability apply more often they do not, they can be very small or very large, either way placing the investor who "winged it" with the "standard discounts" and chose not have a valuation in a losing position; if the "standards" are too low, they forego substantial estate planning benefits; if the "standards" are too high, they run a much greater risk of spending large amounts of back taxes and penalties to the IRS, incurring legal and accounting fees, and finally, many sleepless nights.

Land as an Example. For example, when the partnership's principal asset is land and pays no current return and there are no near term plans for development or sale, this might suggest that returns to limited partners might be non-existent. Therefore, their only potential returns might stem from the continued opportunity for property appreciation, combined with some future hope of return from its sale or development.

However, this does not always suggest that discounts for interests holding land should always be large. It may well be that the land is a highly visible, well situated asset that makes the interests more desirable, and therefore, more marketable, than a partnership interest in land, with limited "sex appeal."

Market Conditions Affect Discounts. Further, the market also drives the degree of discounts, with the potential for wide differences in appeal both over time and by the type of asset. We closely track a number of publicly traded real estate investment trusts (REITs), comparing their market trading price per share, which is a minority price, but with fully marketability (can sell by a call to a stockbroker), to the appraised value per share of their real property holdings.

The result; the market affords a wide degree of minority discounts, ranging from as high as 60% to no discount whatsoever. A close examination of each reveals that a number of investment attributes impact the level of discounts, including items such as the degree of dividend payout of the company's cash flows, the stability of the payout, financial leverage, diversification of properties by type and geography, tenant mix, the strength of management and a host of other factors.

Let's go back to the shopping center investor at the beginning of the article. Suppose the center had no debt, strong management and paid out all of its cash flow to the partners in the form of quarterly distributions. In this circumstance the minority and marketable discounts might be greatly diminished because the limited partner is sharing in the fruits of its success. Therefore, to arbitrarily take two large discounts because the advisor said they were "standard" could be very bad advice.

What About Marketable Securities and Discounts? If you believe our investor, you will apply the same discounts for minority interest no matter what the partnership's asset, whether land, stocks and bonds or even cash. The market simply does not agree with this position and individuals who support such a view are treading on thin ice. For example, publicly traded shares in closed end mutual funds represent minority interests in a mutual fund whose assets might comprise a market basket of publicly traded stocks. *The Wall Street Journal* routinely quotes the market price of closed end fund shares, versus the "net asset value" per share, with the fund's stocks priced at their current trading price. Guess what- the majority trade at or close to their underlying net asset value, sometimes a discount, and sometimes a premium. So where does the "standard" discount theory hold up on minority discounts? It is arguable that marketability discounts might apply, although this a subject for debate another day.

What is the Investor to do? A qualified business appraiser should be retained to value the interest to be gifted. This would typically a full study of the partnership' historic performance, which would then be compared against publicly traded REITs with properties of similar characteristics. Market valuation multiples could then be developed and applied to the subject's cash flow, dividends and appraised value of holdings to develop market based valuation estimates. This sounds simple, but a proper valuation might run 30 to 50 pages to provide the necessary support required by appropriate revenue rulings. While this is no guarantee that the IRS will not challenge the resulting value, is your business appraiser has been objective and unbiased and has provided a well documented and reasonable result, you are on much firmer ground than our hypothetical investor who threw caution to the wind. ♦

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