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THE BEGINNING OF THE END FOR FLPS?

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Introduction. Family Limited Partnerships (FLPs) have enjoyed increasing popularity in recent years as an estate-planning tool, however, various legislative and market forces may be combining to close this window of opportunity. This article will examine the basic structure of and theory behind the FLP and then look at the potential governmental action and market-based phenomena that could affect the use of this instrument going forward.

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Structure of the FLP. In the FLP's most basic format, assets are contributed by an individual into a limited partnership. The limited partnership is then owned by that individual through a small general partnership interest and a large limited partnership interest. The assets contributed to the partnership may vary widely, however, the most common assets contributed are real estate, publicly-traded stocks and/or bonds, stock in privately-held companies, or some combination of the above. After the FLP is formed, the individual then gifts small limited partnership interests to his family members. For reasons explained below, the individual usually takes a discount on the limited partnership interests he is gifting to his family members. The magnitude of the discount can vary widely (from 0% to over 50%) and is dependent entirely on the relevant facts of the specific partnership.

Power to the General Partner. In a typical FLP, the general partner has nearly complete control over the partnership. Powers held exclusively by the general partner may include the amount of distributions paid (if any) to limited partners, the timing of the ultimate disposition of partnership assets, and the overall management of the partnership (including the purchase and sale of partnership assets, the mortgaging of partnership property, the establishment of reserve funds, etc.). Limited partners are usually very constrained with the amount of control they can exercise over the partnership. Depending on governing state law and the applicability of Chapter 14 and other IRS regulations, a limited partner may be essentially powerless to effect any change that would allow the limited partner to realize any value from his or her investment. (Author's note: The results of the application of Chapter 14 and its related provisions under the Internal Revenue Code to FLPs is unclear. To the best of our knowledge, the implications of Chapter 14 have not been fully litigated in tax court and, as a result, Chapter 14 is not well-settled law as of this date. Therefore, a discussion of the impact of Chapter 14 is premature and is beyond the scope of this article.)

Value Ramifications to the Limited Partner. As a result of the ownership/control scenario described above, limited partners generally have very little control over their investment. As a result, under the standard of fair market value, it is reasonable to assume that a willing buyer would pay less than "face value" (also defined as net asset value, or NAV) for a limited partnership interest. Likewise, it is reasonable to assume that a willing buyer would be forced to take a discount on his investment in order to convert it into immediately realizable value (i.e., cash).

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Therefore, it may be appropriate to take discounts on the small limited partnership interest both for minority as well as marketability issues. Again, the applicability and magnitude of a discount depends on the circumstances surrounding the specific FLP as well as the methodologies used in the valuation.

Interest from Capitol Hill and the White House. Congressional and executive interest in FLPs has been percolating for several years. The October 16, 1996, issue of *The Wall Street Journal* noted that "[t]he Joint Tax Committee of Congress is studying issues related to partnerships and other types of business structures…to see if there is any need for legislative action." More recently, the February 4, 1998, issue of *The Wall Street Journal* stated that, in regards to FLPs, "Treasury officials want to eliminate these 'valuation discounts,' except for 'active businesses.' Their proposal would be effective for transfers after whatever date the bill is enacted. Thus, accountants say clients who were considering making such transfers might want to do so quickly to guard against possible legislation."

Monica Lewinsky: Patron Saint of the FLP? We therefore have seen Congressional interest as well as a definitive attack from the Clinton Administration. According to the 2/4/98 *Journal*, the proposals in President Clinton's new budget call for an additional $1.1 billion in revenue generated by the elimination of various tax benefits associated with estate tax planning. It is estimated by the Treasury that adjustments to the current FLP rules would raise the vast majority (about $1.0 billion) of the total $1.1 billion. Of course, this is a budget proposal only and is made by a Democratic President whose influence with the Republican-controlled Congress may be seriously weakened as the result of recently-alleged sex and perjury scandals. The ultimate disposition of the FLP issue is far from settled, however, as noted in the *Journal*, some financial advisors are urging clients to take advantage of the existing environment to avoid any "late-night Washington compromises that slam shut some important financial-planning windows."

Impact of Market Data. Regardless of whether Congressional action on FLPs completely shuts the window, our market research and continued monitoring of various valuation methodologies concerning FLPs has uncovered some interesting trends that indicate the FLP window may nonetheless be slowly closing. These trends mainly concern the valuation of FLP interests holding some real estate component (the majority of the FLP valuations we see) and affect the valuation of FLP interests under the market approaches as explained below.

The Market Approach to Valuation. There are numerous variations of the market approach to FLP valuation. One of the primary methods we utilize with real estate FLPs involves an analysis of the discount to net asset value (NAV) of the public comparables selected. The NAV of a public partnership is based on a 100% controlling interest value of the partnership's underlying real estate assets. For instance, if a public partnership with 100,000 units outstanding owns real estate with a total appraised value of $10,000,000, that partnership is said to have a NAV per unit of $100. If that public partnership trades for $60 per unit on the secondary market, its discount to NAV is calculated as 40%. Therefore, the discount to NAV measures the degree of discount the market gives the public partnership based on the minority (and maybe the marketability) status of the interest. A minority discount is implied due to the fact that the NAV of the public partnership represents the 100% controlling value of the partnership.

Whether or not a marketability discount is also implied in this discount may depend on the liquidity of the market for the public comparable. Most public limited partnerships trade on what is called the secondary market which essentially matches willing buyers with willing sellers. With trading occurring much less frequently, the secondary market arguably is not as liquid as a market for publicly-traded equities such as the New York Stock Exchange. Therefore, although it is difficult to quantify, some of the discount to NAV seen in the secondary market may have some lack of marketability component to it.

So Long to the REITs. Until recently, Real Estate Investment Trusts (REITs) provided an excellent comparable universe to FLPs. Several publicly-traded REITs used to calculate their NAV on an annual basis and publish it in their annual report. Such companies as BRE Properties, USP Realty Trust, New Plan Realty Trust, Duke Realty, and Catellus Development used to be appropriate public comparables for many FLPs, however, none of these REITs publish their NAV any more on an annual basis. Management often cited the cost of annual appraisals as the reason why the practice was discontinued, however, there may also have been

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some desire by management to minimize investor discontent. Based on conversations with management at some of the REITs, investors like to see that they have purchased their REIT shares at a discount to NAV, however, the same investors quickly tire of seeing their stock price below the appraised value of the REIT, year after year. The quick and easy solution for management is to discontinue the annual appraisal.

Publicly-Traded Limited Partnerships: The Long Goodbye ? With the demise of the REIT as a suitable public comparable for real estate FLPs, we are left with an equally-appropriate public comparable – the publicly-traded limited partnership. As opposed to a shareholder in a public REIT, a limited partner in a publicly-traded limited partnership generally suffers from a low or nonexistent distribution as well as more limited avenues of marketability for his partnership interest. Like the REITs used to do, many public partnerships perform annual appraisals of their real estate holdings, some done independently and some done by the general partner. Perhaps the leading source for information on publicly-traded limited partnerships is *The Partnership Spectrum*, published by Partnership Profiles, Inc. The *Spectrum*, edited by Spencer Jefferies, publishes an annual issue outlining the discount to NAV for the universe of publicly-traded limited partnerships it monitors.

Narrowing Discounts. In its three latest annual discount studies, the *Spectrum* notes that the average discount to NAV has fallen dramatically over the prior four years. In 1994, the *Spectrum* calculated the average discount to NAV at 48% for the public partnerships it tracked. From this level, the average discount has fallen to 41% in 1995, to 38% in 1996, and to 30% in 1997. In analyzing this trend, the *Spectrum* has noted a distinct change in investor sentiment. In their May/June 1993 issue (back when the average discount to NAV was 48%), the *Spectrum* (then called *The Perspective*) noted that "[t]he name of the game in the LP secondary market is spelled Y-I-E-L-D. Very few buyers are willing to wait years and years before realizing any cash return on their investment, especially with so many general partners unwilling to liquidate their partnership anytime soon." In effect, the *Spectrum* was saying that the expected long-term holding period for partnership properties left investors only with the often-paltry (or nonexistent) distributions on these investments as their only source of return. The result of this was a large discount to NAV.

Feeding the REIT Monster. As opposed to their 1993 analysis of the market, the May/June 1997 edition of the *Spectrum* (when the discount had narrowed to 30%) cited the following influence on discounts to NAV: "While secondary market buyers certainly factor current distribution yields into their pricing models, the potential for reaping near-term capital gains from partnership liquidations is even more appealing than quarterly distributions which help pass the time until the big check arrives in the mail at liquidation time." This is a significant change in strategy from 1993 when partnerships generally had no liquidation horizon for their properties. Indeed, many of the public partnerships tracked by the *Spectrum* have adopted programs of orderly liquidation for their properties and have actually started to sell their properties. Reasons for this change of heart include a continuing boom in the real estate market from the recessionary period of the early 1990's, a soaring stock market that has worried investors seeking alternative investment vehicles, the comparatively low returns offered in the fixed income markets, and the voracious real estate appetite of REITs. Indeed, REITs have largely replaced publicly-traded limited partnerships as the public's real estate investment of choice. We think this phenomena is primarily due to the superior liquidity and yield offered by REITs. Most REITs are traded on national exchanges that are far more liquid than the secondary market. This allows investors the ability to buy and sell REIT shares immediately as opposed to waiting what may be months or years to sell limited partnership interests on the secondary market. Furthermore, REITs must pay out 95% of their income to shareholders whereas limited partners in publicly-traded partnerships are at the mercy of their general partner for distributions. Also, the universe of information on REITs is usually better as many REITs are followed by the stock analysts of the large brokerage and securities houses.

What does this mean for your FLP ? If this public partnership liquidation trend continues, the impact on FLP valuation could be twofold. First, as public partnerships continue to liquidate their properties, discounts to NAV should narrow further as the investors' waiting period to cash out of their partnership shortens. Of course, this arguably may not have much of an effect on the discounts appropriate for private FLPs as the valuation analysis may show that the private FLP has no such orderly

liquidation plan and a higher discount to NAV for the limited partnership interest is therefore justified. The second and more meaningful impact of the public partnership liquidation trend on FLP valuation could be that the secondary market for publicly-traded limited partnerships eventually disappears, forcing business appraisers to seek alternative data to use in the market approach to valuation.

Conclusion. The ultimate outcome of FLP valuation is unsure. Uncertainty with the application of Chapter 14, potentially unfavorable legislative action, and changing market dynamics affecting public comparables all add to the confusion surrounding the issue. While reports of its death may be premature, what is certain is that FLPs are attracting more attention these days, most notably from people who can do something about them. Furthermore, various valuation yardsticks that were available in the past are either withering or have died. We believe the message to the estate planning attorney is twofold. First, a blind application of any discount to an FLP is dangerous without a fully-supported and well-documented appraisal that addresses the implications of control, liquidity, and current and expected yield on the subject FLP. Second, given the unpredictability of governmental action and the financial markets, the prudent course of action for the estate planning attorney may be to act sooner rather than later. ♦

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