Recent Developments in Appraising Interests in Family Investment Entities

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San Antonio Estate Planners Council

San Antonio Country Club

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Valuation Advisors and Investment Bankers

www.hfbe.com

HFBE Tax Court Testimony

- Jelke v. Commissioner
- McCord v. Commissioner
- Helis v. Commissioner (U.S. Court of Claims)
- Kerr v. Commissioner
- Dunn v. Commissioner
- Davis v. Commissioner
- Cook v. Commissioner
- Jones v. Commissioner
- DiSanto v. Commissioner
- Robertson v. Commissioner (Federal District Court)

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FLP Valuation cases

- McCord
- Lappo
- Peracchio
- Robertson
- Temple
- Kelley

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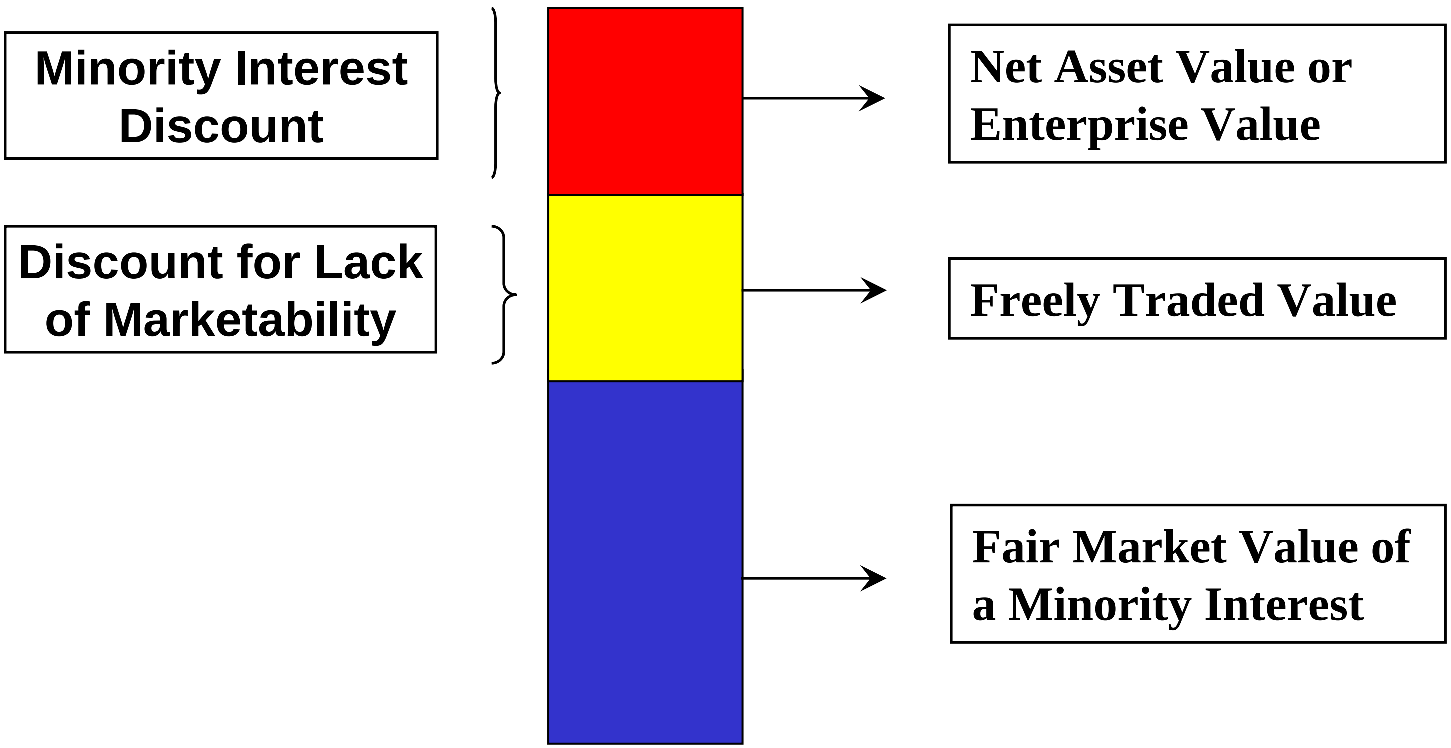
Traditional Valuation Methodology

Family Partnership



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Comparison of McCord Discounts

	Discount Percentages for All Categories			
	HFBE	Bajaj	Average	Tax Court
Overall Discount	49 %	16 %	32.5 %	32 %
Minority Interest Discount				
Common Stocks	16 %	6 %	11 %	10 %
Municipal Bonds	11 %	6 %	8.5 %	10 %
Real Estate Partnerships	40 %	9 %	24.5 %	23 %
Real Estate	40 %	40 % *	40 %	40 % *
Oil & Gas	33.5 %	33.5 % *	33.5 %	33.5 % *
Lack of Marketability Discount	35 %	7 %	21 %	20 %

*Adopted HFBE result

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The Bajaj Study Averages

Averages	Percent Discount
Overall Average	22.2%
Unregistered Shares	28.1%
Registered Shares	14.0%
Large Blocks (20-40%)	31.4%
Large Blocks (No Distress)	27.1%
Large Blocks (No Distress and Not Registered)	31.9%

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What the Court Meant

Group	# of Transactions	Percent Discount
Overall Study	88	22%
Block Size > 25%	22	29%
Large and Non-Distressed	8	27%
Unregistered	4	34%

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Recent Record of McCord Judges Regarding Restricted Stock Studies

- **Gale** - *Estate of Helen J.Smith,* (T.C. Memo 1999-368). Affirmed the use of restricted stock studies.
- **Gerber** – *Estate of Gladys Cook,* (T.C. Memo 2001-170). Both petitioner <u>and</u> IRS experts used restricted stock studies to determine discounts of around 35%.
- **Halpern** – In *Estate of Richie C. Heck* (Korbel & Bros. Inc.) (T.C. Memo 2002-34), Dr. Bajaj is testifying for the <u>taxpayer</u> and, instead of the 7% he found in McCord he uses a 25% discount for lack of marketability citing the restricted stock studies. This is a highly profitable company with significant net cash flow. The judge endorses this methodology.
- **Swift** – In *Estate of Sam Homer Marmaduke* (T.C. Memo 1999-342), the judge unequivocally endorses restricted stock studies.
- **Colvin** – *Estate of William G. Adams, Jr.* (T.C. Memo 2002-80), Judge Colvin accepts both restricted stock studies and pre-IPO studies, here.

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Summary of Restricted Stock Studies

	Holding Period	Name of Study	Years Covered in Study	Average Discount (%)		
Pre-1990 Studies	Two years, non-cumulative	SEC Overall Average (a)	1966 - 1969	25.8	34.3	Decreasing Restrictions Increasing Liquidity Decreasing Discounts
		SEC Nonreporting OTC Companies (a)	1966 - 1969	32.6		
		Gelman (b)	1968 - 1970	33.0		
		Trout (c)	1968 - 1972	33.5 (m)		
		Moroney (d)	(l)	35.6		
		Maher (e)	1969 - 1973	35.4		
		Standard Research Consultants (f)	1978 - 1982	45.0 (m)		
		Silber (g)	1981 - 1988	33.8		
1990-1997 Studies	Two years, cumulative	FMV Opinions, Inc. (h)	1979 - April 1992	23.0	22.8	
		Management Planning, Inc. (i)	1980 - 1996	27.1		
		Bruce Johnson (j)	1991 - 1995	20.0		
		Columbia Financial Advisors (k)	1996 - Feb. 1997	21.0		
Post-1997 Studies	One year	Columbia Financial Advisors (k)	May 1997 - 1998	13.0	13.0	

Source: Shannon Pratt, "Valuing a Business". Guide to Business Valuations, Practitioners Publishing Co. (Jan. 2001)

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		Columbia Financial Advisors (k)	1996 - Feb. 1997	21.0		
Post- 997 Studies	One year	Columbia Financial Advisors (k)	May 1997 - 1998	13.0	13.0	

Source: Shannon Pratt, "Valuing a Business". Guide to Business Valuations, Practitioners Publishing Co. (Jan. 2001)

What the Court Said was Important

McCord was an:

“Investment Partnership”

– Not subject to the risks of the small operating companies of the restricted stock studies

We agree

– Holding Period not a factor

We disagree

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Comparison of Discounts

	Lappo Discounts (a)			
	Discount Percentages for All Categories			
	Taxpayer (b)	IRS (b)	Average	Tax Court
Overall Discount	50.7%	16.1%	33.4%	35.4%
Minority Interest Discount				
Marketable Securities	8.5% (c)	8.5%	8.5%	8.5%
Real Estate Partnerships	35.0%	8.5% (d)	21.8%	19.0% (e)
Weighted Average	24.1%	8.5%	16.3%	15.0% (e)
Lack of Marketability Discount	35.0%	8.3%	21.7%	24.0%

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Comparison of Discounts

	Peracchio Discounts			
	Discount Percentages for All Categories			
	Taxpayer Expert I	IRS	Average	Tax Court
Overall Discount	40.0%	18.7%	29.4%	29.5%
Minority Interest Discount				
Marketable Securities	7.7%	4.4%	6.1%	6.0%
Lack of Marketability Discount	35.0%	15.0%	25.0%	25.0%

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Jelke v. Commissioner Jelke v. Commissioner

	Discount from NAV			
	Taxpayer Expert	IRS Expert	Average	Tax Court
Gross Asset Value	$188,636	$188,636	$188,636	$188,636
Capital Gains Tax Liability (GAAP)	$51,627	$51,627	$51,627	$51,627
Capital Gains Tax Deduction	$51,627	$21,082	$36,355	$21,082
as % of GAV	27.4%	11.2%	19.3%	11.2%
NAV	$137,009	$167,554	$152,282	$167,554
Minority Interest Discount	25%	5%	15%	10%
Lack of Marketability Discount	35%	10%	23%	15%

Estate of Jelke v. Commissioner, 89 T.C.M. (CCH) 1397 (2005)

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Valuation Discounts…Time to Rethink

- **Restricted Stock studies have not been totally persuasive in Tax Court**
- **Congress and the IRS think “discounts” are a loophole**
- **Tax Court Arguments are <u>Investment</u> oriented**
- **NICE is based on <u>Investment</u> Theory**

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Added ROR Components for the LP Investor

- **Lack of Control- additional Required Return**
  - Asset class returns (e.g., large cap, munis, etc.)
    - Average
    - Above average
  - Quality of Management?
  - Governance of Entity
    - Partnership Agreement
    - Voting-Non-voting
    - LP Interest v. Assignee Interest

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Volatility (Risk) and the Cost of Illiquidity

Estimated Incremental Illiquidity Premiums with
Historical Returns and Standard Deviation by Asset Class

Asset Class	Historical Volatility	Minimum PIC Illiquidity Premium (bp)	Maximum PIC Illiquidity Premium (bp)
U.S. Government Bonds (10 Yr.)[a]	**5.1%**	**50**	**100[e]**
Municipal Bonds [d]	*5.1%*	*75*	*125*
Corporate Bonds [c]	*8.7%*	*100*	*150*
Junk Bonds[c]	**22.0%**	**300**	**350**
U. S. Large-Cap [a]	*20.3%*	*200*	*250*
International Large-Cap [b]	*19.4%*	*225*	*275*
North American Real Estate Equities[b]	20.4%	275	325
U.S. Small-Cap[a]	**34.1%**	**500**	**600[f]**

Boldface-sourced result; *italics* -interpolated result

Sources:

[a] Stocks, Bonds, Bills and Inflation, 1997 Yearbook.

[b] Commercial Real Estate. Ibbotson. 2006. Standard deviation calculated for years 1990-2005.

[c] Using Yield Spreads to Estimate Expected Returns on Debt and Equity Ian A. Cooper, Sergei A. Davydenko.

[d] Lehman Brothers Municipal Bond Index, 1995-2005.

[e] Dr. Alexander Kempf (Universität zu Köln) and Dr. Marliese Uhrig-Homburg (Universität Mannheim).

[f] Frazier. Valuation Strategies. 2005.

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Investment Thesis for an FLP

- An Investment in an FLP is a very long term investment
- The majority (if not all) of the economic return will come when the FLP is liquidated
- The Buyer of the interest wants to buy low
- The Seller wants to sell high
- Both are realistic and informed

What is this NICE Method, Anyway?

- **New Methodology for valuing fractional interests in investment holding entities:**
  - Family Limited Partnerships
  - Limited Liability Companies
  - S Corporations
- **Based on Modern Portfolio Theory**
  - Income Based
  - Considers Risks and Rewards
  - Based on Market Expected Returns
    - Asset Allocation
    - Expected Holding Period

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In Search of Fair Market Value

- **Fair Market Value is that one PRICE that best fits the parameters of the BUYER-SELLER expectations**

- **That is, the one price that, for all years of the FLP's duration, provides a ROR that is neither too high nor too low.**

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Bid – Ask Spread

- **The NICE Method balances the BUY side (“bid”) with the SELL side (“ask”) of the Fair Market Value equation.**

- **Expected returns based on the Seller’s asking price (high) is the MINIMUM ROR case**

- **Expected returns based on the Buyer’s bid price (low) is the MAXIMUM ROR case**

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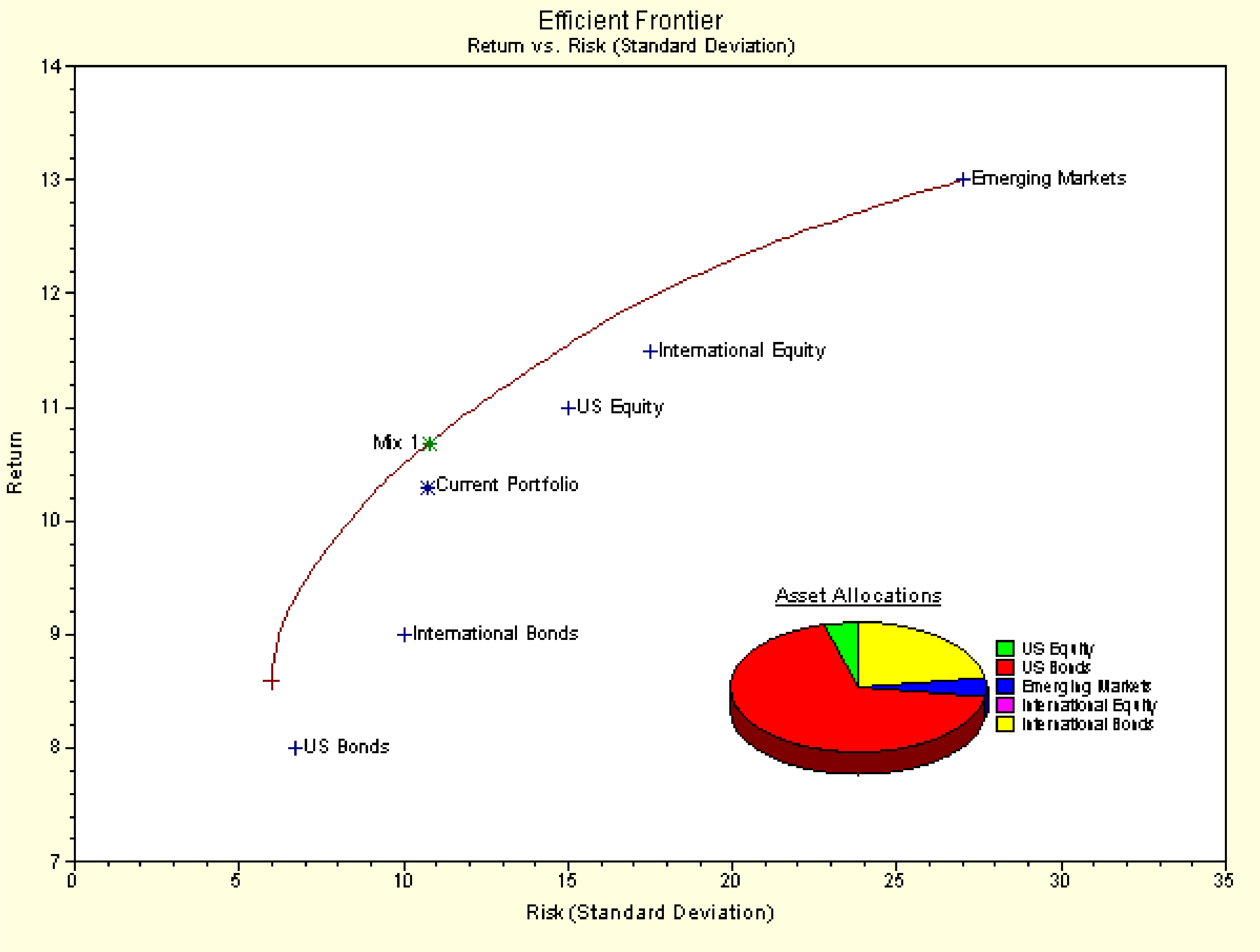
The FLP is a Portfolio of Assets



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Returns by Asset Class

Total Returns, Income Returns, and Capital Appreciation of the basic Asset Classes
Summary Statistics of Annual Returns from 1926 to 2002

Asset Class	Geometric Mean	Arithmetic Mean	Standard Deviation
Large Company Stocks	10.2%	12.2%	20.5%
Small Company Stocks (Total Returns)	12.1	16.9	33.2
Long-Term Corporate Bonds (Total Returns)	5.9	6.2	8.7
Long-Term Government Bonds	5.5	5.8	9.4
Intermediate-Term Government Bonds	5.4	5.6	5.8
Treasury Bills (Total Returns)	3.8	3.8	3.2

Source: Ibbotson Associates

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The Components of Fair Market Value: Returns, Risk and Time

$$PV = \frac{FV}{(1+i)^n}$$

where FV = the expected future value

i = the annual cost or rent of money described as the required ROR or "discount rate" -**RISK**

n = the number of years from the present to the expected future realization of funds through the sale of the asset

HOLDING PERIOD

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FLP ROR Components

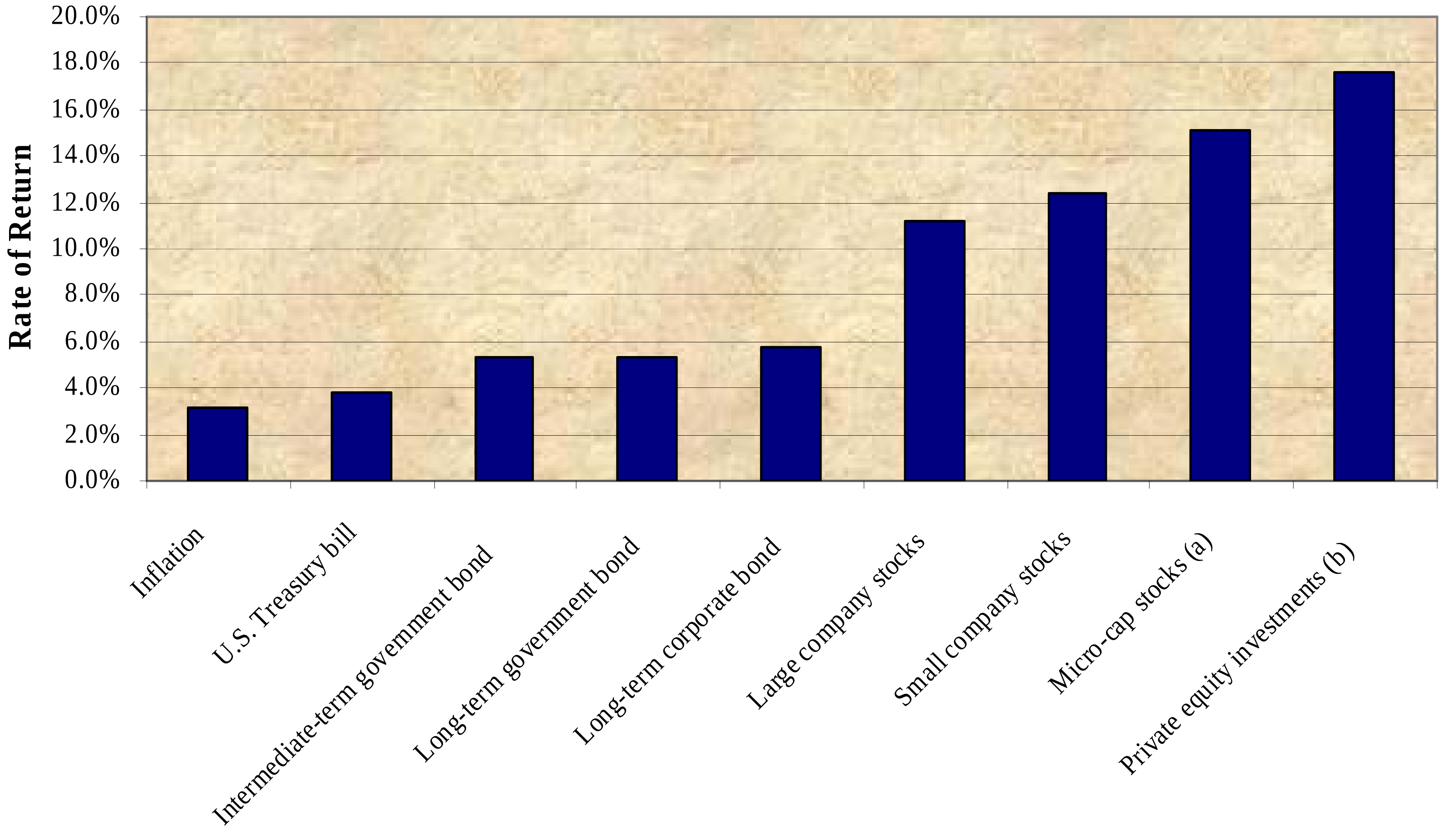
Asset allocation → *Market Risk*

Asset management → *Managerial Risk*

Distributions → *Current yield*

Expected duration → *Liquidation*

Risk and Rate of Return ("ROR")



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Long Term Equity Returns

Total Returns: (a)

From =>	1926	1936	1946	1956	1966	1976	1986	1996	2001
Till the end of									
1926	11.6								
1936	8.1	33.9							
1946	6.4	6.8	-8.1						
1956	10.1	12.2	15.7	6.6					
1966	**9.9**	11.2	12.6	9.0	-10.1				
1976	9.2	**10.1**	10.6	7.8	5.0	23.8			
1986	10.0	10.8	**11.4**	9.7	9.1	14.7	18.5		
1996	10.7	11.5	12.1	**11.1**	11.1	15.0	15.6	23.1	
2001	10.7	11.5	12.0	11.0	**11.0**	14.1	14.0	12.7	-11.9

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Added ROR Components for the LP Investor – Lack of Control

- **Lack of Control- additional Required Return**
  - Asset class returns (e.g., large cap, munis, etc.)
    - Average
    - Above average
  - Quality of Management?
  - Governance of Entity
    - Partnership Agreement
    - Voting-Non-voting
    - LP Interest v. Assignee Interest

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Added ROR Components for the LP Investor – Lack of Marketability

Asset Class	Historical Volatility	Minimum PIC Illiquidity Premium (bp)	Maximum PIC Illiquidity Premium (bp)
U.S. Government Bonds (10 Yr.)	**5.1%**	**50**	**100**
Municipal Bonds	*5.1%*	*75*	*125*
Corporate Bonds	*8.7%*	*100*	*150*
Junk Bonds	**22.0%**	**300**	**350**
U. S. Large-Cap	*20.3%*	*200*	*250*
International Large-Cap	*19.4%*	*225*	*275*
North American Real Estate Equities	20.4%	275	325
U.S. Small-Cap	**34.1%**	**500**	**600**

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ROR - Interest

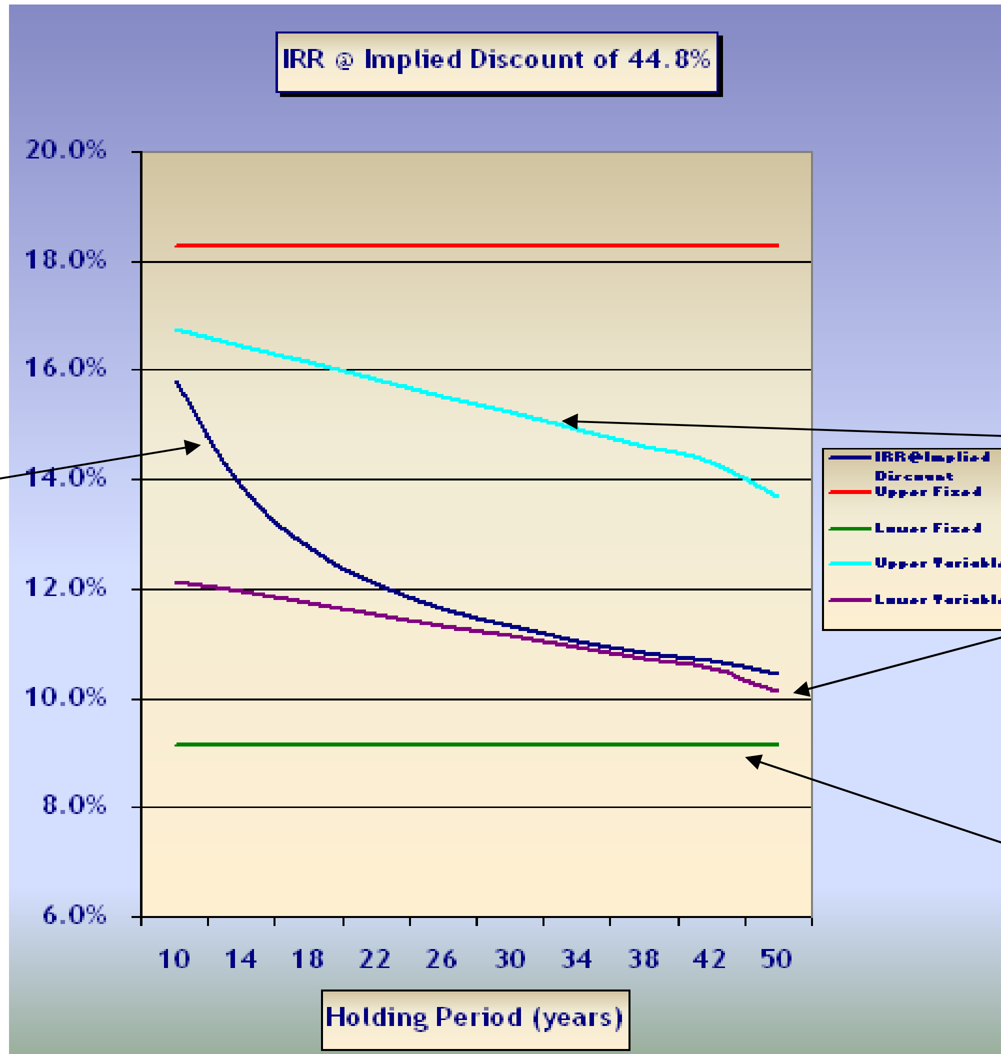
Internal Rates of Return Expected to be Realized over Subsequent Holding Periods

		Subsequent Holding Period in Years									
		10	14	18	22	26	30	34	38	42	45
ROR-Interest		14.7%	13.7%	13.1%	12.7%	12.5%	12.3%	12.1%	12.0%	11.9%	11.9%
Ptnshp Expctd Ret.	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%	11.1%
Max. Expected Ret.	5.0%	16.1%	15.8%	15.5%	15.2%	15.0%	14.7%	14.4%	14.1%	13.8%	13.6%
Min. Expected Ret.	2.0%	13.1%	13.0%	12.9%	12.8%	12.6%	12.5%	12.4%	12.3%	12.2%	12.1%

Investment Term 35 years

ROR Over Time

Rate Of Return



Periodic Max. Boundary

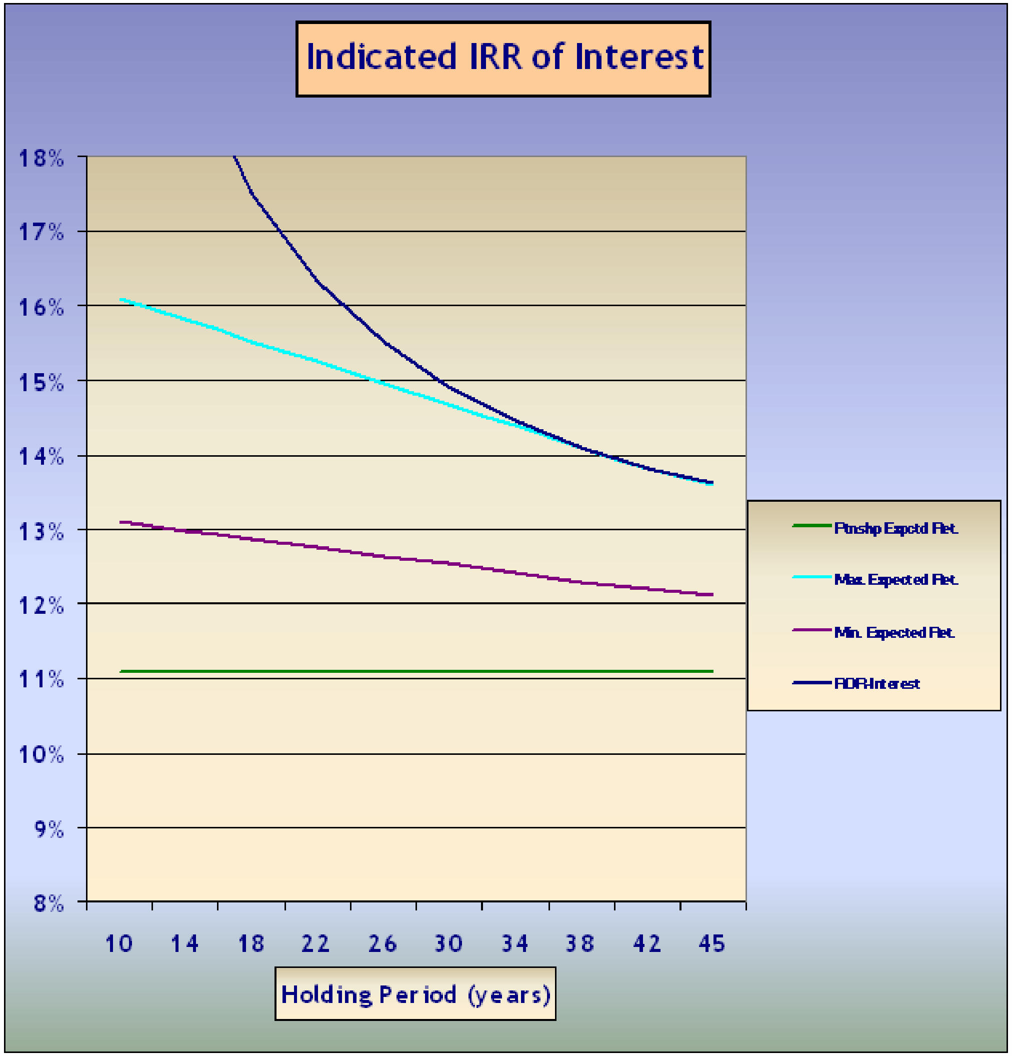
Periodic Min. Boundary

Min. Return Boundary

Estimated Price - $1,000,000….Too Low

Net Asset Value	
Marketable Securities Portfolio	$12,500,000
Net Asset Value	$12,500,000
NAV per 1 percent LP Interest	$125,000
Interest Being Valued	22.00%
NAV of Interest	**$2,750,000**

Estimated Price (Fair Market Value)	**$1,000,000**



Estimated Price - $2,250,000….Too High

Net Asset Value	
Marketable Securities Portfolio	$12,500,000
Net Asset Value	$12,500,000
NAV per 1 percent LP Interest	$125,000
Interest Being Valued	22.00%
NAV of Interest	**$2,750,000**

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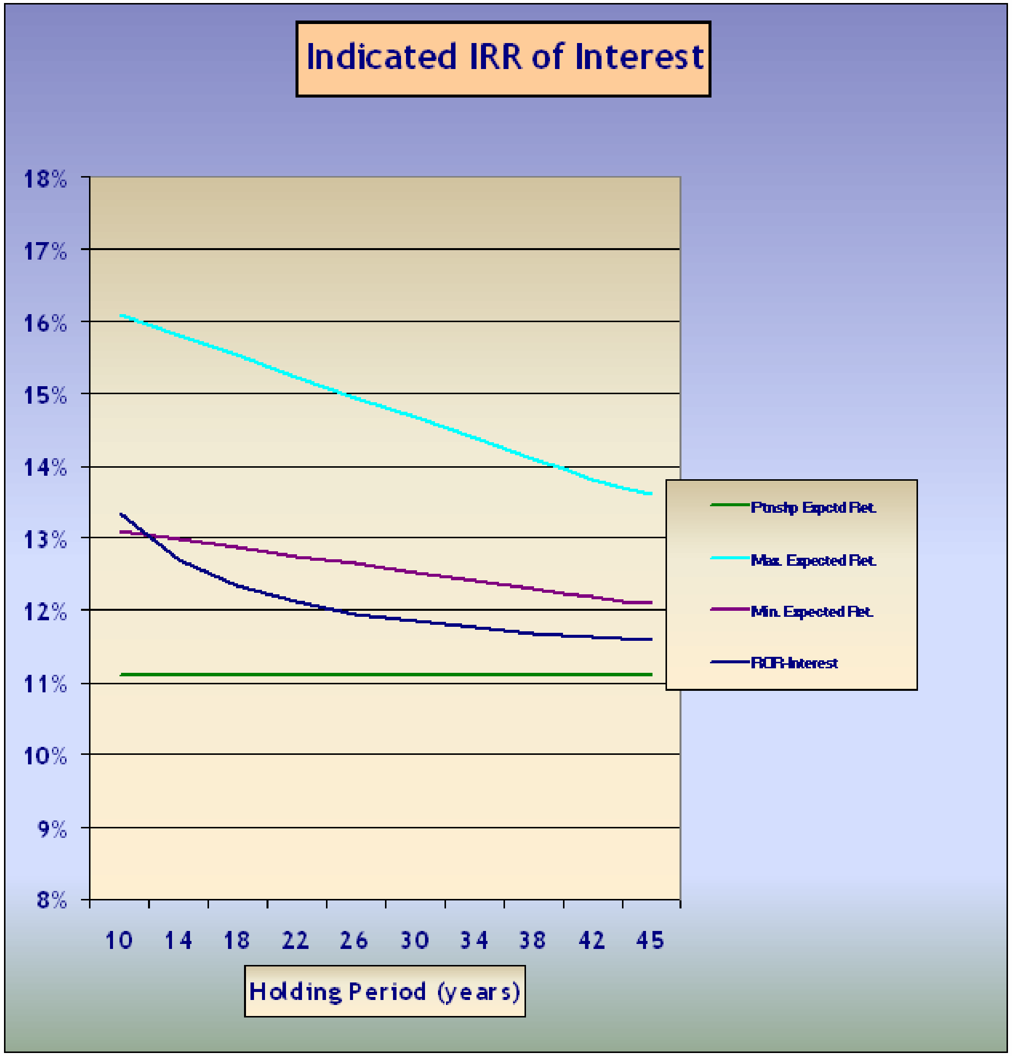

Estimated Price - $1,775,000…Final Answer!

Net Asset Value	
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Net Asset Value	$12,500,000
NAV per 1 percent LP Interest	$125,000
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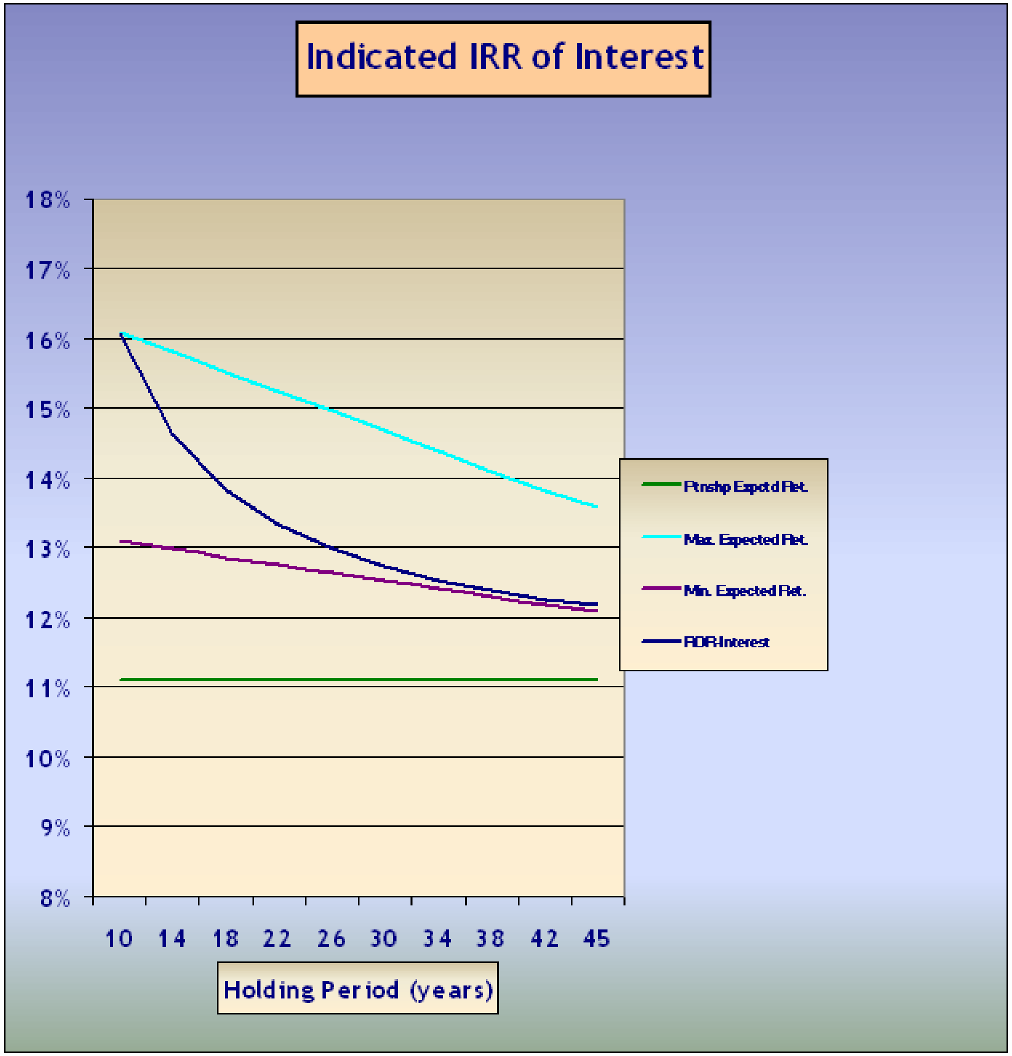
NAV of Interest	**$2,750,000**

Estimated Price (Fair Market Value)	$1,775,000



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The NICE Method v. "Traditional"

Traditional Methodology

Indicated Discounts at CHEVI FMV

NAV (100%)		$ 12,500,000
Minority Interest % to be Valued	22.00%	2,750,000.00
Discount for Lack of Control	12.00%	$ 330,000
Marketable, noncontrolling interest value		$ 2,420,000
Discount for lack of marketability	26.65%	$ 644,930
Fair market value		$ 1,775,070

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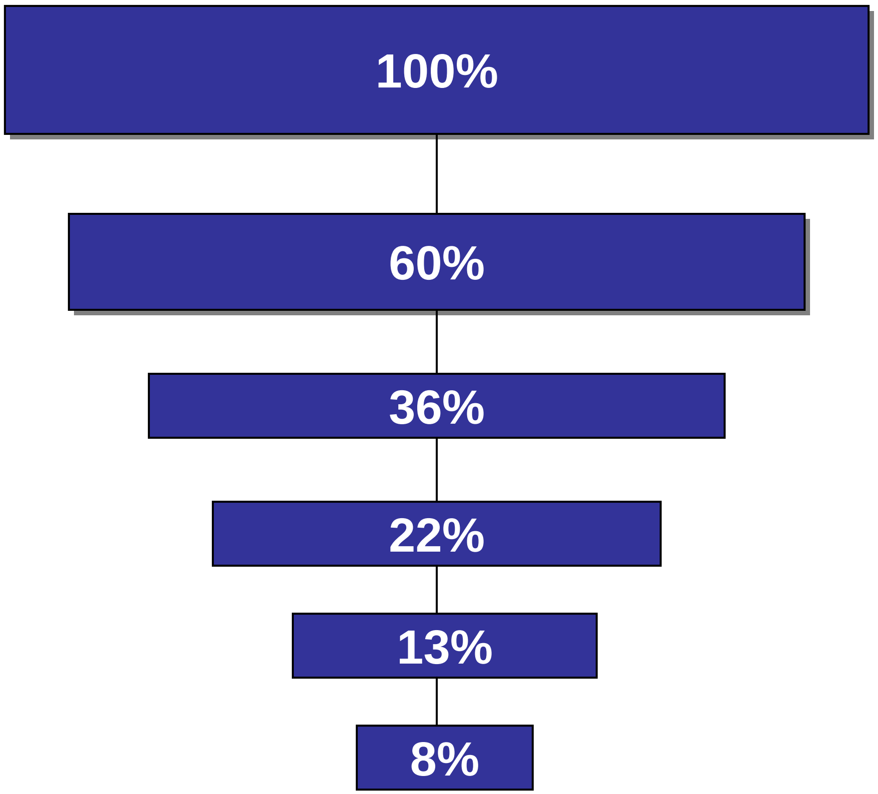
Tiered Entities and Discounts



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Regulation and Legislation

Internal Revenue Service
United States Department of the Treasury

The Tax Gap

Table 1 Gross Tax Gap by Type of Tax		
Type of Tax	**Gross Tax Gap ($ Billions)**	**Share of Gross Tax Gap (%)** [1]
Individual Income	245	71
Corporate Income	32	9
Employment	59	17
Estate	8	2
Excise	Not Available	
TOTAL	**345**	**100**

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Department of the Treasury

A Comprehensive Strategy for Reducing the Tax Gap

U.S. Department of the Treasury

Office of Tax Policy

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Appraiser Regulation

- **Pension Protection Act of 2006**
  - The Good News
    - It seeks to define “Qualified Appraisers” and “Qualified Appraisals”
  - The Bad News
    - **Appraiser Penalties -** Civil penalties for “substantial” or “gross” valuation misstatement
      - Determination of error made by IRS
      - Does not apply for IRS appraisers

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Pension Protection Act of 2006

- **Greater accountability on any individual performing tax-related valuations, including:**
  - Tighter tolerances giving rise to valuation misstatements
  - Increased penalties on valuators and taxpayers for such misstatements
  - The imposition on appraisers of the same standards of practice before the IRS that now are imposed on tax practitioners

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Pension Protection Act of 2006

- **New Penalties on Appraisers and Related Valuation Worries**

The Pension Protection Act reduces the threshold for…penalties for reporting incorrect valuations for income, estate and gift tax purposes. It eliminates the "good faith/reasonable" basis defense to the imposition of a gross income tax misstatement of value for contribution to charity..

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What is a Qualified Appraiser?

1. **Experience**
   - a. **Discipline (general)**
   - b. **Industry (specific)**
2. **Appraisal Credentials**
3. **Education**
4. **Track Record**
   - a. **Articles, speeches, etc.**
   - b. **Court testimony**

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Qualified Appraisal

Complies with appropriate:

1. **Technical Valuation Standards**
2. **Informational disclosures**
3. **Report content and format**
4. **Ethical standards**

Uniform Standards of Professional Appraisal Practice (USPAP) specifically cited in PPA.

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FLPs are Under Attack - Appraisers are under a cloud

- **Tax "Scams" Involving Appraisers**
  - Donations of Intellectual Property
  - Donations of Automobiles
  - Conservation Easements
  - Charitable Donations of Remainder Interests
  - Subprime Lending

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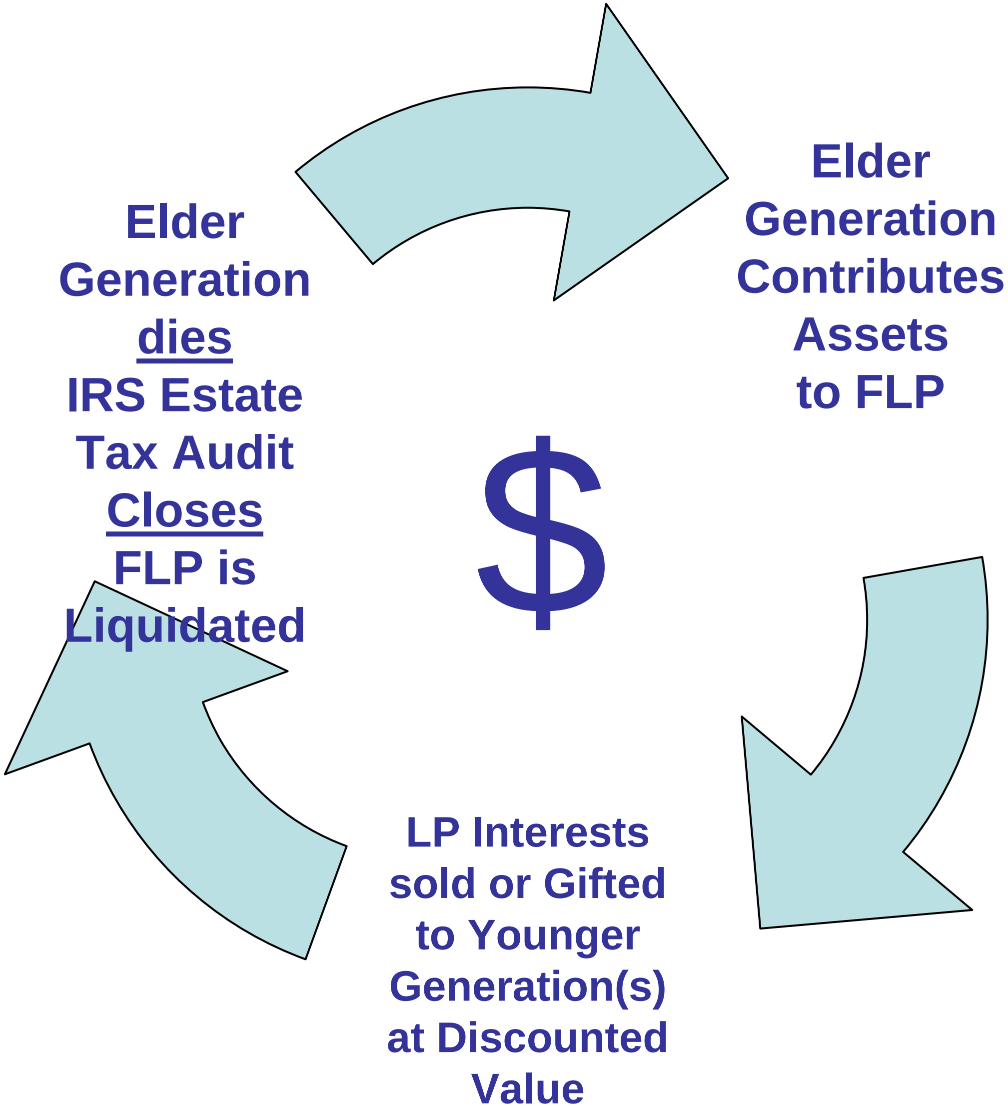
Recycling of Dollars



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Joint Committee on Taxation

OPTIONS TO IMPROVE TAX COMPLIANCE AND
REFORM TAX EXPENDITURES

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

January 27, 2005

JCS-02-05

As requested by Senators Grassley and Baucus, the report describes a number of proposals that would reduce the size of the tax gap by curtailing tax shelters, closing unintended loopholes, and addressing other areas of noncompliance in present law.

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Trusts & Estates

COMMITTEE REPORT

VALUATIONS

Valuation Assurance Clauses

Here's a way to substantiate discounts in family limited partnerships to make the IRS and Tax Court feel better

By William H. Frazier, senior managing director, Howard Frazier Barker Elliott, Inc., Dallas

Estate planners often find themselves in a quandary: They follow all known rules and guidelines in devising a family limited partnership (FLP) plan for their client, but still have to cross their fingers that the Internal Revenue Service will accept the plan. The valuation of FLP interests is a particularly tricky area. What's the IRS thinking when it rejects the valuation attached to your client's FLP? Such rejections are a recurring problem. But I have a solution that, hopefully, will satisfy all parties: valuation assurance clauses.

There's no dispute that the IRS fervently believes that taxpayers routinely undervalue their FLP interests. A host of Tax Court decisions reveal that the court at least partially accepts the Service's viewpoint. Is the dispute really about FLP valuation theory? I don't think so. Rather, the valuation "problem" is really a debate over the sanctity of the FLP itself. The IRS sees the FLP as a device to avoid taxes. Given the string of "split the baby" decisions in FLP valuation cases, the Tax Court appears somewhat sympathetic to this perspective.

The essence of the FLP valuation problem boils down to the battle over the discount for lack of marketability. The IRS believes FLP interests shouldn't be subject to a significant discount, based

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