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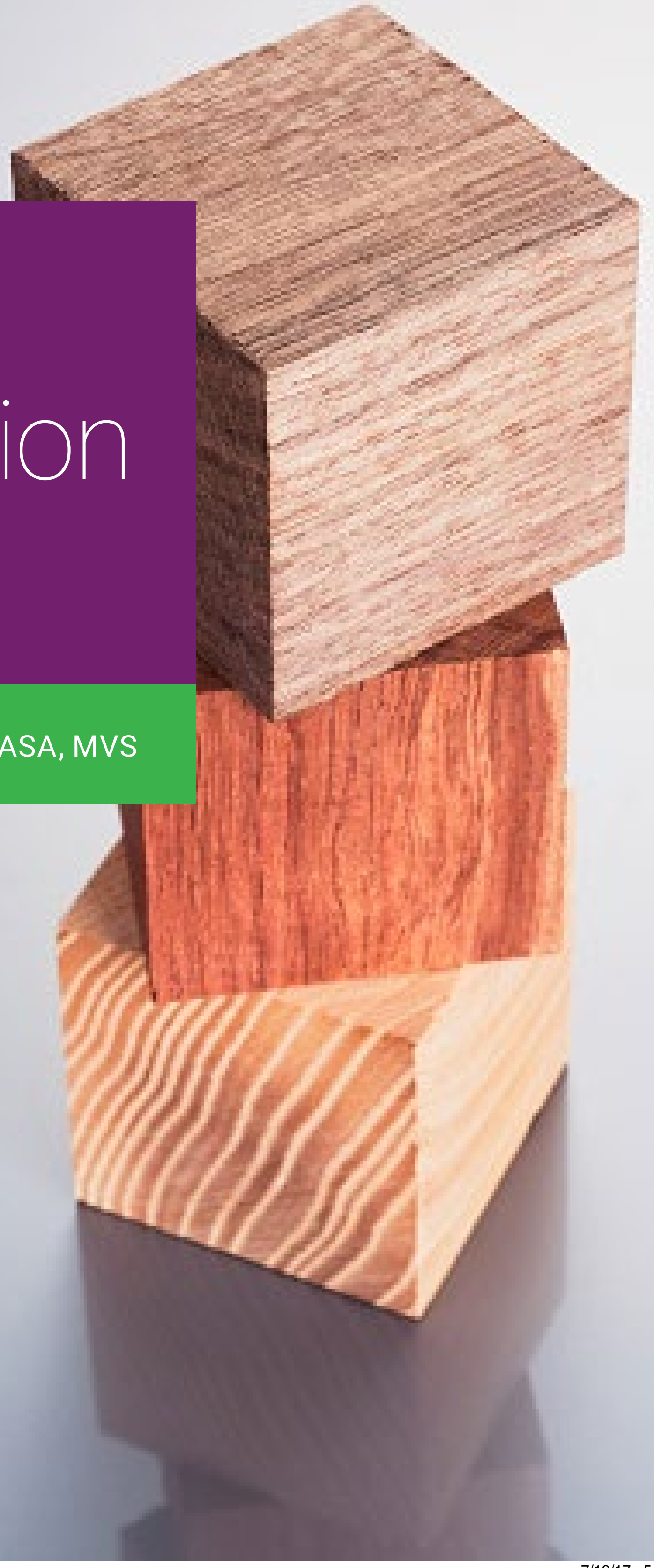
Understanding Business Valuation

A Practical Guide to Valuing Small to Medium Sized Businesses



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Chapter 21
Estate and Gift Valuations

Learning Objectives

In this chapter, I will attempt to explain the following:

- Valuation rules for estate and gift tax purposes
- Valuing family limited partnerships (and similar entities) for estate and gift tax purposes
- How the valuation analyst should do the job the right way

Introduction

I started this chapter in the last edition by writing "Although the rumors continue to circulate (and they have for years) that discounts for family limited partnerships (FLPs) and other similar entities are going to be legislated out of existence, the legislation never seems to get too far in Congress." Toward the end of 2016, there were more hearings, this time, trying to change Section 2704 of the IRC. In English, they are at it again! By the time this edition of the book is published, who knows what these folks will be up to. Therefore, I am going to tell you about this topic as of late 2016/early 2017.

Not much has changed that affects how we perform valuations for estate and gift tax purposes. But with that being said, if the valuation analyst is going to work in this arena, he or she must know the rules. And there are definitely rules.

Business valuation assignments performed for estate and gift tax purposes are subject to the laws found within the IRC and regulations. This is not optional. It is the law. But as with all laws, there always seems to be interpretations that are questioned. Though it is not my intent to turn this book into a tax treatise, the valuation analyst needs to be aware of the rules. If the valuation analyst is not an accountant, he or she should work with an accountant, a tax attorney, or someone who knows the rules. If the valuation analyst is an accountant, find someone who understands the rules.

Besides the IRC and regulations, it is also a pretty good idea for the valuation analyst to be familiar with revenue rulings, private letter rulings, Tax Court decisions, and all types of other stuff that relate to this area. The valuation analyst should also know that there are various penalties included in the tax law that penalize taxpayers and sometimes valuation analysts for substantially understating a tax liability. Besides the malpractice issues that I addressed earlier in this book, the valuation analyst certainly does not want to end up in a position where he or she or the firm is laying out money in the form of penalties.

Penalties for Undervaluation on Estate and Gift Tax Returns

If the valuation analyst is going to work in this arena, he or she should be aware of the potential penalties that he or she and the client face. IRC Section 6662 provides for penalties against taxpayers for undervaluation of assets on estate and gift tax returns. These penalties are based on the percentage difference between the value reported on the estate or gift tax return and the value finally determined. The client faces the following possible penalties:

Value Per Tax Return as a Percentage of the Final Value	Penalty
More than 65%	0%
More than 40%, but less than 65%	20%
40% or less	40%

So, what does this mean? It means that if the valuation analyst's client gets whacked with a penalty, he or she or his or her insurance carrier may have to write a check. Valuation analysts are subject to IRC Section 6701 penalties when it is determined that the valuation analyst aided and abetted the taxpayer in understating the tax. The maximum penalty that can be assessed against the valuation analyst is $1,000. However, with the passage of the 2006 Pension Protection Act (PPA), the rules changed. Although this seems to be a long time ago, those who have not worked in this profession before are not familiar with The Act, and so I am going to spend a little time discussing it.

2006 Pension Protection Act

One of the provisions of the PPA is that for valuations for charitable contribution purposes, the appraisal[1] has to be a "qualified appraisal" performed by a "qualified appraiser." These definitions were expanded to apply to all fair market valuations for all purposes in the Technical Correction Act of 2007. In IRS Notice 2006-96, the IRS defined these two terms. An appraisal is considered to be a qualified appraisal if

> it complies with all of the requirements of Reg. § 1.170A-13(c)—the preexisting regs—(except to the extent the regs are inconsistent with Code Sec. 170(f) (11)), and is conducted by a qualified appraiser in accordance with generally accepted appraisal standards. For example, the appraisal is consistent with the substance and principles of the *Uniform Standards of Professional Appraisal Practice* (USPAP), as developed by the Appraisal Standards Board of the Appraisal Foundation.
>
> A qualified appraiser is an individual who has earned an appraisal designation from a recognized professional organization or has otherwise met minimum education and experience requirements under IRS regs; regularly performs appraisals for compensation; and meets any other such requirements prescribed by the IRS (Code Sec. 170(f)(11)(E)(ii)). An individual won't be considered a qualified appraiser for any specific appraisal unless he demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and hasn't been prohibited from practicing before IRS at any time during the three-year period ending on date of the appraisal (Code Sec. 170(f)(11)(E)(iii)).

Final regulations have not been issued under IRC Section 170 or any other IRC section relating to these definitions. One thing that the CPA-valuation analyst should note is that *Statement on Standards for Valuation Services* (SSVS) No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (AICPA, *Professional Standards*, VS sec. 100), is considered to be consistent with the substance and principals of the USPAP. Therefore, compliance with SSVS No. 1 would be the same as complying with the USPAP.

One relatively new penalty that is applicable to valuation analysts is the IRC Section 6694 penalty. According to Treasury Department Circular No. 230, appraisers are now considered to be non-signing tax preparers. The analyst is subject to the penalty if the appraisal is a substantial portion of the return or the claim for refund, and the applicable standards of care under IRC Section 6694 are not met. If this penalty is applicable, the valuation analyst is subject to a penalty that is in an amount greater than

a. $1,000, or
b. 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

1 I am using the term appraisal here because the Pension Protection Act of 2006 uses this language. For this purpose, there is no distinction between an *appraisal* and a *valuation*. In addition, a valuation analyst is an appraiser in this discussion.

In addition, under IRC Section 6695A, there are substantial and gross valuation penalty tests for valuation understatements for returns filed after August 17, 2006. A substantial valuation penalty is applicable when the value of the property claimed on an estate or gift tax return is 65 percent or less of the amount determined to be the right amount. A gross valuation misstatement exists when the value of the property is 40 percent or less of the amount determined to be correct. The penalty is based on any additional tax due to an undervaluation exceeding $5,000.

IRC Section 6695A codifies this appraisal penalty as the lesser of

- *a.* the greater of $1,000 or 10 percent of the underpayment, or
- *b.* 125 percent of the gross income received by the appraiser for the appraisal services.

This penalty is in addition to the existing $1,000 penalty under IRC Section 6701.

To avoid the IRC Section 6695A penalty, the appraisal must meet a "more likely than not standard," which has yet to be defined by the IRS. The exception to this rule is that the appraisal was more likely than not the correct appraisal. According to the IRS, appraisers will avoid this penalty if they follow professional standards, perform due diligence, and follow commonly accepted methods. However, this has not been codified in any Treasury regulations.

Finally, valuation analysts may also incur sanctions under Treasury Department Circular No. 230, which governs the right of CPAs and others to practice before the IRS. The IRS can now institute proceedings to disqualify appraisers from practice before the IRS when the appraiser has been assessed a penalty under Sections 6694, 6695A, or 6701, or any other relevant penalty provisions. The IRS has established a standard that provides them with the ability to institute procedures to disqualify an appraiser if it is determined that the appraiser "acted willfully, recklessly or through gross incompetence with respect to the proscribed conduct." This terminology seems to suggest that unless there is a pattern of negligence, the IRS would probably not start proceedings against an appraiser. However, if a disqualification does occur, the appraiser is barred from presenting evidence or testimony in any administrative proceeding before the IRS, regardless of whether the evidence or testimony would pertain to an appraisal made prior to or after the effective date of the disqualification. This information can also be shared with other government agencies. Now that I have created a sufficient amount of fear, let's discuss valuations for estate and gift tax purposes.

Revenue Ruling 59-60

All valuations that are performed for estate and gift tax purposes are guided by Revenue Ruling 59-60. Not only have I discussed this ruling throughout the book, but chapter 16 was devoted solely to it. There is also a copy of it in appendix 6. I am not going to repeat all of that stuff here. Just reread it and follow it for guidance.

Chapter 14 Guidelines

Chapter 14 of the IRC (Sections 2701–2704) is an important part of the tax law to know if the valuation analyst performs this type of work for family entities. The rules are very complex and confusing. I will try to explain the more important provisions as we go along.

Case Law

Although a valuation analyst should not necessarily perform his or her role by relying on case law, this is an area of practice in which having knowledge of the law certainly helps. There are plenty of resources available with lists of valuation court cases, as well as the full written decisions. Although the analyst should be familiar with the courts' findings, he or she should not rely on specific court cases in the valuation analysis or report because more than likely, actual facts and circumstances will be different than those reported in the case law. It is the job of the attorney to make arguments and support them with case law, not the valuation analyst.

The Valuation Report

Preparing a business valuation report for estate and gift tax purposes should really be no different from preparing a well-written report for other purposes in which fair market value is the standard of value. If the valuation analyst follows the guidance that I have tried to provide throughout this book, he or she should do fine.

Valuations performed for gift tax situations are subject to the *adequate disclosure* rules (see exhibit 21.1 later in this chapter). In fact, if a discount is taken in the valuation report, a box needs to be checked on the gift tax return that effectively says to the IRS "audit me." In order for the statute of limitations to begin running, a gift tax return must meet the adequate disclosure requirements. These days, one of the most common types of reports is for the valuation of an interest in a family limited partnership. Although there are rumors that the IRS requires detailed reports to be attached to estate tax returns, this is not stated in the IRC or the regulations. However, there must be sufficient information provided in the report about any discounts (valuation adjustments) that are factored into the conclusion, so why not do a detailed report?

The FLP Valuation

FLPs have grown in popularity as an estate planning tool and a way to reduce transfer tax values. Although this discussion refers to FLPs, many of the concepts discussed also apply to family limited liability companies (LLCs) created primarily as asset-holding companies. Business valuation analysts should be aware of the issues involved in valuing these types of interests and how to prepare a report that is less likely to be challenged by the IRS, or, if challenged, one that will more likely allow the challenge to be resolved in favor of the concluded value.

Valuation analysts need to do more than focus on what discounts they can use to reduce the value of an FLP interest. After all, this is usually the main fight with the IRS (see chapters 14 and 15 for a discussion on discounts). The FLP agreement and other partnership documents must be thoroughly analyzed before the valuation analyst can begin to render an opinion of value. The final report must at least contain certain information about the assignment—the nature of the interest being valued, the terms of the partnership agreement, and the financial condition of the entity.

This discussion is designed as an overview of the FLP valuation process and the items to consider. It is designed to help the valuation analyst prepare valuation reports more effectively and perhaps minimize the opportunity for the IRS to challenge his or her conclusion of value.

What Is an FLP?[2]

Simply stated, an FLP is a nontaxable entity that is created and governed by statute and whose partners (both general and limited) and assignees consist mainly of family members.

It is nontaxable because, as a partnership, it is a pass-through entity. Unlike a corporation, which is subject to corporate-level income tax, a partnership does not pay any income taxes at the entity level. Partners will be liable for income taxes on their proportionate share of any partnership income, regardless of whether it is distributed in the form of cash.

A limited partnership is created under and governed by the Revised Uniform Limited Partnership Act of the state in which it is formed. Though they are similar in many respects, each state's Limited Partnership Act contains features that are different (although some states' acts are the same).

The FLP is also affected by various sections of the IRC, as is the valuation of interests in an FLP.

Even the term *family member* is carefully defined in IRS regulations. Members of the family are defined as the transferor or the transferor's spouse, the transferor or spouse's lineal descendants, and their spouses. This definition includes adopted children or offspring of the transferor's children but does not include aunts, uncles, cousins, and the like.

2 Many attorneys are using limited liability companies (LLCs) instead of limited partnerships due to differences in the rights of members versus limited partners. Legally, these entities are different, but there are more similarities in the valuation of these two types of entities than differences. The valuation analyst must be aware of the rights (or lack of rights) that the various ownership interests have in order to prepare the valuation properly.

Many of the issues that arise in appraising FLPs become legal interpretations of the partnership agreement, rather than *pure* valuation issues. Although as valuation analysts it is important that we know and understand the issues, it is imperative that we leave the “lawyering” to the lawyers.I have said this over and over again. If there is any doubt in the valuation analyst’s mind regarding the nature of the assignment or the terms of the partnership agreement, the client’s attorney should be the one to explain it to the valuation analyst, not the other way around.

Why Are FLPs Attractive?

FLPs are particularly attractive as estate planning tools because, through the creation of an FLP, the following apply:

- Parents or grandparents have the ability to indirectly transfer interests in family-owned assets without losing control of them.
- A high degree of protection against creditors can be achieved. This is because a partner’s creditor is legally unable to gain access to the assets in the partnership.
- The assets can be kept in the family, which is an objective of many families. This can be achieved by placing restrictions on the transfer of partnership interests, especially in the event of divorce, bankruptcy, or death of a partner.
- Problems pertaining to undivided or fractionalized interests when a property is gifted to several individuals can be avoided. This can be especially important in the case of real estate properties.
- When family-owned assets are placed in a partnership, advantages can arise through economies of scale and diversification.
- A great deal of flexibility can be achieved through the partnership agreement, which can provide broad investment and business powers. These can be amended as the family’s needs change, as long as all partners are in agreement.
- The partnership is a pass-through entity and does not pay income taxes.
- The gifting or transfer of an ownership interest in a limited partnership may be made at a lower value than that interest’s pro rata share of net asset value. The reason for this is because a limited partnership interest is likely to be both noncontrolling and nonmarketable.

What Exactly Is the Assignment?

As stated early in this book, the valuation analyst should enter into a written contract with the client with the purpose of explaining the precise nature of the assignment that the valuation analyst is going to perform. The importance of having a clear understanding of what the valuation assignment is cannot be overemphasized. It is important that the parameters of the assignment found in box 21.1 become a part of the valuation report.

BOX 21.1 Valuation Assignment Parameters

1. The name of the client (for instance, the person who engaged the valuation analyst). The client is responsible for identifying the nature of the interest to be valued.
2. The nature of the interest being valued (for example, general partner interest, limited partner interest, or assignee interest). It is important to note here that the thing being valued is not a percentage interest in any or all of the assets owned by the partnership but, rather, an interest in the partnership itself.
3. The size of the interest being valued. Size can be represented by a percentage interest amount, the number of units or shares, or even a dollar amount.
4. The valuation date and the purpose for which the valuation is being performed (for instance, whether it is for estate planning [gifting] or estate valuation purposes).
5. The standard of value. The retainer agreement should provide a definition of the standard of value that will be determined in the valuation. These standards are defined in the following tax regulations:

    Estate planning (gifting)—Treasury Regulation 25.2512-1

    Estate valuation (after death)—Treasury Regulation 20.2031-1(b)

    Both of these sections define the standard of fair market value as follows:

    The fair market value (of the property being valued) is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

    This definition should appear in the report as well.

What Documents Are Necessary for Preparing the Valuation Report?

The analyst should obtain the following documents before beginning the assignment:

1. The agreement of partnership (or other type of business agreement depending upon the form of the entity), as well as a copy of the certificate of limited partnership that has been filed with the state where the partnership was created. The certificate is an important document because it gives notice of the formation of the limited partnership and the limited liability of the limited partners and discloses some of the terms of the partnership agreement. Without this document, the possibility exists that the FLP will not be recognized by the IRS. If the valuation analyst is not familiar with the Limited Partnership Act of the state of formation, he or she should also obtain a copy of it.
2. A list of the assets that were initially contributed to the partnership, as well as documentation of any assets that were subsequently contributed.
3. Valuations of real estate and other assets held by the partnership as of the valuation date (for example, market values of marketable securities). If the partnership owns interests in other closely held businesses or partnerships, these interests must be separately appraised before the value of the FLP interest can be determined.
4. Financial statements and tax returns for the partnership for a reasonable number of years or since inception. If it is a new partnership, these will not exist.
5. The general partner's anticipated policies regarding distributions or an IRC Section 754 election. The IRC Section 754 election will be covered later.
6. If the FLP is ongoing, a history of distributions, if any, made to partners. If the entity is new, management's intended policy regarding distributions should be obtained.
7. Information such as minutes of meetings of partners or other documents, if they exist, may give the analyst some insight into the intent of the donor at the time of formation of the partnership.

How Does Revenue Ruling 59-60 Help?

Revenue Ruling 59-60 provides basic guidelines for valuing shares of closely held corporations. It is also a valuable guide to valuing FLPs. Every valuation report of a family limited partnership interest should closely follow Section 4 of Revenue Ruling 59-60, which enumerates the factors the valuation analyst should consider in his or her valuation.

Most of the information necessary to describe the nature of the FLP and its history can be found in the certificate of partnership and the partnership agreement. This section of the report is often overlooked because many valuation analysts prefer to concentrate on the valuation calculations and the discounts selected. However, it is important to make a thorough review of the partnership agreement and to include a list of the pertinent aspects of it in the report.

Remember, our assignment is to determine the fair market value of an FLP interest, not the fair market value of the underlying assets. That is what the valuation analyst should be concentrating on in his or her report. Provisions in the agreement provide the rights (or lack of rights) of the general and limited partners and should be used, where possible, to support the analysis and quantification of the discounts.

What Is Chapter 14?

Chapter 14 of the IRC was enacted in October 1990 and outlines the special valuation rules that must be adhered to when valuing interests in closely held companies and partnerships. The basic premise behind this section is that when valuing business interests that are to be transferred between family members, the valuation analyst should ignore restrictions that would not exist if the transaction was between unrelated third parties.

This chapter consists of four sections, three of which actually relate to FLPs. If the partnership does not comply with the provisions of this chapter, the IRS may determine that the partnership does not exist for tax purposes and value the underlying assets directly in calculating the applicable gift or estate tax.

The provisions of the partnership agreement should comply with the sections of Chapter 14. The major items contained in an FLP agreement are listed in box 21.2, along with the applicable sections of Chapter 14.

BOX 21.2 **FLP Agreement Provisions with Chapter 14 Compliance**

Provision	Chapter 14 Section
Formation	2703
Purpose	2703
Term	2704(b)
Management	2704(a)
Capital contributions	2703
Allocations of profit and loss	2701
Distributions	2701
Transfer restrictions	2703 and 2704(b)
Dissolution	2703 and 2704(b)

IRC Section 2701 addresses special valuation rules used for lifetime gifts when a junior equity interest (corporate, partnership, or LLC) is transferred from one family member to another and the transferor retains a senior equity interest in the company. In this instance, *senior* and *junior* interests refer to interests that are not equal economically, such as preferred stock versus common stock. They do not refer to *general* or *limited* partners as such because general and limited partners are often economically the same. Although they have disproportionate liability and management responsibilities, this, alone, does not make a general partner interest *senior* to a limited partner interest.

For this reason, the special valuation rules contained in IRC Section 2701 do not apply to a gift of a partnership interest in which all items of income and loss are shared in the same proportions by all partnership interests. A reading of the partnership agreement will determine whether or not the FLP is a *pro rata* partnership in which the only differences between the general partner interest and the limited partner interest are management rights and the extent of liability exposure. Not only should this provision be included in the agreement, but it should be followed by the entity. On audit, the IRS will request documents related to distributions, including cancelled checks, to see if the entity is complying with this provision.

Section 2703 deals with restrictions placed on the rights of the transferee in the partnership interest. This section provides that the value of any property is to be determined without regard to the following:

- Any option, agreement, or right to acquire or use the property at a price less than fair market value
- Any restriction on the right to sell or use the property

These rules do not apply when the following occurs:

- There is a bona fide business arrangement.
- It is not a device to transfer the property for less than full and adequate consideration.
- Its terms are comparable to similar arrangements entered into by persons in arm's length transactions.

What is the significance of IRC Section 2703? The term *property* in IRC Section 2703 does not mean the assets contributed to the FLP by the partners because those assets are 100 percent owned by the FLP. Once the assets have been contributed to the FLP, no partner or assignee has a right to receive, possess, or use the assets. What they do have is a right to possess their general and limited partner interests. Because it is the interest in the FLP that is the property for purposes of IRC Section 2703, whether this section applies depends upon the restrictions placed on the rights of the transferees in the partnership agreement.

Whether or not IRC Section 2703 applies is for the client or client's attorney to decide, not the valuation analyst. The valuation analyst is retained to determine a conclusion of value for a partnership interest (not a partnership asset). At most, the valuation analyst can be alert for provisions in the agreement and contact the client if anything appears questionable.

Under this IRC section, the IRS will argue that the restrictions in the agreement are more onerous than the restrictions would exist between two unrelated parties, and as a result, the agreement is not valid. If the IRS wins this argument, then a partnership does not exist, and the actual gift made was the underlying assets, rather than an interest in an FLP.

IRC Section 2704 deals with lapsed voting and liquidation rights. IRC Section 2704(a) treats certain lapsed voting or liquidation rights in an FLP as deemed transfers that become subject to gift or estate tax. Generally, this IRC section becomes applicable if there is only one general partner and this partner is an individual. Voting rights lapse if, at the time of death, this general partnership interest becomes a limited partnership interest, and the general partner's rights to liquidate the partnership lapse as a result. The issue becomes how to measure that loss in rights.

Many experts conclude that the best way to avoid triggering IRC Section 2704(a) is to have a general partner that is a corporation or other entity. In the alternative, an FLP could have more than one general partner if the partners are individuals and there is a provision for succession from one to another should one die. These provisions must be spelled out in the partnership agreement.

IRC Section 2704(b) disallows consideration of certain restrictions (called the *applicable restrictions*) on liquidation rights in valuing the transfer of an interest in a family-controlled entity. An applicable restriction is any limitation on the ability to liquidate the entity, in whole or in part, that is more restrictive than the limitations that would apply under state law, if the restriction did not exist in the agreement. If the liquidation restrictions in an agreement are more restrictive than state law, under IRC Section 2704(b), the valuation analyst should value the interest utilizing state law provisions, rather than the more restrictive rights in the agreement.

There are a number of states that have changed their Limited Partnership Act to state that the provisions of the Partnership Agreement control liquidation restrictions; therefore, many LPs have been formed in these states. For this reason, it is imperative for the valuation analyst to understand the appropriate state law.

How Does All This Affect the Valuation Assignment?

Many valuation analysts are concerned with the size of the discounts taken in an FLP valuation because they believe that this is the biggest concern to the IRS. Although the IRS is concerned with excessive discounts, there is case law that has dealt with the issue of whether the partnership truly exists. The IRS has raised this issue by either attacking the reason for the formation of the partnership or raising Chapter 14 issues, specifically IRC Sections 2703 and 2704.

Remember, if the IRS can win on these issues, then the FLP is not seen as a valid entity; therefore, the gifts become gifts of the underlying assets directly, rather than partnership interests (in other words, no discounts).

Some of the original cases that dealt with these issues are the following:

- *Baine P. Kerr, et ux. v. Commissioner*, 113 TC 449
- *Estate of Albert Strangi v. Commissioner*, 115 TC 35
- *Ina F. Knight v. Commissioner, et vir v. Commissioner*, 115 TC 36
- *Church v. United States*, 85 AFTR 2d 2000-804

This is not intended to be an exhaustive list; it is merely an example of some of the issues that the IRS has brought up on audit that have been decided by the courts. There are other, more recent cases, but in general, the taxpayers have prevailed in these cases because the facts and circumstances have not been egregious. In general, the courts have allowed the entities to stand because the partners understood the agreement when they signed it and the courts have chosen not to override that choice.

Section 2036

This section of the IRC does not directly relate to valuation but has been used effectively by the IRS in fighting valuations of interests in FLPs that are included on estate tax returns.

The following is a reproduction of IRC Section 2036, "Transfers with Retained Life Estate."

> **TRANSFERS WITH RETAINED LIFE ESTATE**
>
> **2036(a) General Rule.** The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

2036(a)(1) the possession of enjoyment of, or the right to the income from, the property, or

2036(a)(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

2036(b) Voting Rights.

2036(b)(1) In General. For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

2036(b)(2) Controlled Corporation. For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing a least 20 percent of the total combined voting power of all classes of stock.

2036(b)(3) Coordination with Section 2035. For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.

2036(c) Limitation on Application of General Rule. This section shall not apply to a transfer made before March 4, 1931; nor to a transfer made after March 3, 1931, and before June 7, 1932, unless the property transferred would have been includible in the decedent's gross estate by reason of the amendatory language of the joint resolution of March 3, 1931 (46 Stat. 1516).

Although the IRS has not won every case on this issue, they have been relatively successful. When the IRS prevails on this issue, the amount of the gift, without discounts, is included in the decedent's estate. Some of the cases that have been decided under IRC Section 2036 are as follows:

- *Estate of Reichardt v. Commission*, 114 TC 144
- *Estate of Harper v. Commissioner*, TC Memo 2002-121
- *Kimbell v. U.S.*, 2003 WL 138081, Doc 2003 2946, 2003 TNT 22-12 (N.D.TX. 2003); vacated and remanded by 5th Circuit Court of Appeals (No. 03-10529)
- *Estate of Strangi v. Commissioner*, 115 TC 478 (2000), affirmed in part and revised in part 293 F. 2D 279 (5th Cir. 2002), remand TC Memo 2003-145
- *Estate of Stone v. Commission*, TC Memo 2003-309

This is not an all-inclusive list of the IRC Section 2036 cases that have been ruled on, but these particular cases demonstrate the issues that the IRS is raising in this area. Since this list was compiled, there have been a number of additional cases. Some of the decisions have favored the IRS, whereas others have favored the taxpayer. IRC Section 2036 is a legal and tax argument, not a valuation issue. However, because many of us advise clients on these issues or work with attorneys in setting up or maintaining FLPs, some key things to keep in mind are provided in box 21.3.[3]

BOX 21.3 IRC Section 2036 Considerations

1. Select FLP assets carefully.
   a. Do not transfer a personal residence to an FLP.
   b. To avoid the appearance of an implied agreement, do not transfer substantially all the decedent's assets to the FLP. Make sure the decedent retains, OUTSIDE of the FLP and in the client's own name, sufficient assets to meet his or her own personal needs.
   c. Transfer business assets to an FLP. A closely held business makes a great asset to contribute to an FLP. The active involvement of the FLP in a legitimate business activity may be the best way to avoid inclusion under IRC Section 2036.

(Box continued)

3 Adapted from "A Practical Approach to FLPs: It's Not All Gloom and Doom," a presentation made by David Aughtry Esq. at the 2004 AICPA National Business Valuation Conference. Copyright 2008 by David D. Aughtry. Used with Permission.

BOX 21.3 **IRC Section 2036 Considerations** *(continued)*

2. Avoid certain patterns of distributions.
   a. Avoid timing distributions to coincide with personal expenditures. It makes the FLP look like the decedent's personal pocketbook.
   b. If possible, do not make distributions and allow the FLP to accumulate its income.
   c. If distributions are necessary, have the FLP agreement provide for distributions at the same time each period, for example, quarterly distributions can be made. Another option is to determine distributions on the basis of the profitability of the FLP's assets.
   d. When distributions are made, make sure they are proportionate to the interest owned by the partners.
   e. Always keep detailed records of distributions—approval process used, reasons, and so on.
3. Avoid giving the client "control" over the contributed assets.
   a. Avoid placing the client in a position where he or she has control over the partnership distributions.
   b. Do not make the client general partner or allow the client to have enough power to remove the general partner and place himself or herself or another person in the role of general partner.
   c. Avoid placing the client in a position where he or she can dissolve the FLP.
   d. Avoid giving the client's attorney-in-fact management responsibilities.
   e. Do not waive general partner's fiduciary duties. Do NOT provide that the general partner will be relieved of normal fiduciary responsibilities.
   f. Consider hiring an unrelated party to handle the day-to-day management of the FLP and the general partner entity. This also supports the legitimate business purposes of the FLP.
4. Structure the FLP to include other interest holders.
   a. If possible, have other family members contribute property to the FLP to enhance the bona fide status of the FLP. This supports the FLP's legitimate business purpose.
   b. Include unrelated interest-holders. The inclusion of unrelated interest-holders may help prevent a court from disregarding the general partner's fiduciary duties.
   c. Always involve other partners and general partner entity owners in negotiation and implementation process. Documenting the involvement of the other interest-holders may help establish the applicability of the bona fide sale exception to IRC Section 2036.
5. Observe formalities.
   a. Observe all the formalities. Don't just rely on accounting entries. Avoid accruing certain payables; leave a paper trail.
   b. Get the books made promptly after the FLP is created.
   c. Open the FLP checking account promptly after FLP formation.
   d. Retitle assets in FLP's name promptly.
6. Don't treat an FLP like a testamentary arrangement.

Be aware and cautious of setting up an FLP with a widow or widower who is on his or her death bed. This could be problematic because there would only be limited post-transfer history, and it creates the impression that the transaction is testamentary in nature.

More Court Cases

Because IRC Section 2036 is only effective for estate tax returns, the IRS needed a different mechanism to challenge gift tax returns when the Chapter 14 arguments did not work. The arguments they have raised are indirect gifts of the assets and the step transaction doctrine.

The indirect gift argument arises when a gift is made before the agreement is executed or the assets are transferred to the FLP. In this case, the IRS has been able to argue that the transfer is not a gift of an FLP interest, but a gift of the underlying assets. There have been several cases on this issue, both victories and defeats for the IRS, including the following:

- *Senda v. Commissioner*, T.C. Memo 2004-160 (affirmed by 8th Circuit Court of Appeals, 97 AFTR 2d 2006-419)
- *Linton v. U.S.*, 104 AFTR 2d 2009-5176, 638 F Supp 2d 1277 (DC WA, 2009) (affirmed in part, reversed and remanded in part by 9th Circuit Court of Appeals, 107 AFTR 2d 2011-565, 630 F3d 1211)
- *Holman v. Commissioner*, 130 TC 170 (affirmed by 8th Circuit Court of Appeals, 105 AFTR 2d 2010-1802)
- *Bianca Gross v. Commissioner*, T.C. Memo 2008-221

The step transaction argument arises when the entity is formed and the gifts are made shortly thereafter. The IRS has argued that these are essentially one transaction (formation and transfer) and, therefore, an indirect gift of the underlying assets. This issue was raised in the *Linton* and *Holman* cases referenced previously.

Court cases should probably be reviewed on a fairly regular basis if the valuation analyst is going to work in this area because there are frequently new cases and new issues. The preceding lists of cases are only a brief sample, not an all-inclusive list.

Things to Consider in the Valuation Process

The basic characteristics of the transferred interest in the FLP, combined with specific provisions in the FLP agreement and state law, form the foundation for the valuation adjustments used in arriving at the fair market value of the transferred interest in the FLP. I have included some of the factors to be considered in determining appropriate valuation adjustments in box 21.4.

BOX 21.4 Factors to Consider Affecting Valuation

Factors to be considered that are found in the partnership agreement:

- A provision (term-of-years provision) in the partnership agreement that the partnership shall continue to exist for a definite term of years, unless it is dissolved or liquidated prior to this date.
- No guarantee by the managing general partner or general partners of the return of any partner's capital contributions, nor any allocations of profits or losses, nor any distributions of distributable cash (not even enough to cover the annual taxes of the partners).
- Approval rights of limited partners required for certain major decisions; otherwise limited partners and assignees are excluded from participation in management.
- How the election of new managing general partners is accomplished.
- A provision that distances the limited partners and assignees from the assets of the FLP.
- The right of the managing general partner(s) or general partner(s) to determine distributable cash.
- Capital call provision obligating partners and assignees.
- Limitations on the voluntary and involuntary transferability of general partner, limited partner, and assignee interests.
- The presence of rights of first refusal.
- Consent of all partners required for a transferee or assignee of an interest in the partnership to become a substituted limited partner.
- Whether the managing general partners or general partners are required to make an IRC Section 754 election.
- Limitations on the right of the general partner to withdraw from the partnership prior to the expiration of its stated term and provision that, should the general partner exercise his or her power to withdraw early, his or her general partner interest shall become a limited partner interest and he or she may also be subject to damages for breach.
- Limitations on the right of a limited partner and assignee to withdraw from the partnership prior to the expiration of its stated term.
- Provisions for dissolution of the partnership mirroring state law.

Factors to be considered but may not be found in the partnership agreement:

- The reputation, integrity, and perceived competence of the partnership management and general partner(s)
- The number of investors in the partnership
- The type of assets owned by the partnership
- Whether or not the assets of the partnership are well-diversified
- The amount of financial leverage inherent in the partnership's capital structure
- The caliber of the information flow from the partnership and the general partner(s)
- The current and historical amount of cash actually distributed to partners and assignees
- Underlying cash flow coverage of yearly distributions made to partners and assignees
- The size of the interest
- The universe of interest buyers
- The default rules under state law

What About Methodology?

What is the best approach for valuing an FLP interest? Which methods can and should be used? Section 4 of Revenue Ruling 59-60 states the following:

> (a) ...in general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.
>
> (b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

This seems to imply that some type of asset-based approach would be the most appropriate and, indeed, the only approach to valuing an FLP interest. Whereas an asset-based approach might be a frequently used approach to valuing such an interest, it is by no means the only one. Often, an income approach may be used, as well. The approach to be used should be determined based on the underlying assets of the FLP, whether or not there is a history of distributions to the partners, and how extensive and consistent the distributions were. Depending on the assets held by the partnership, a market approach could also be utilized. Depending on the circumstances of the case, more than one method may be appropriate.

In *Estate of Etta H. Weinberg, et al. v. Commissioner* (TC Memo 2000-51), the court accepted both an income approach and an asset-based approach for determining the value of the decedent's minority interest in a limited partnership that owned and operated an apartment complex. The court found that the taxpayer's use of the net asset value method under the asset-based approach was warranted because the property would retain most of its inherent value regardless of rental income production. Furthermore, the court found that the capitalization of the three-year average of distributions under the income approach was also appropriate. The findings of the court illustrate that the reliance on one approach (particularly the asset-based approach) for the valuation of FLPs is not always sufficient or relevant.

In deciding on the methodology to apply to the valuation of partnership interests, the valuation analyst must consider many different facts.

> The IRS' argument to disregard the partnership agreement is made easier when the consultant uses only an asset-based approach to value an FLP interest, and the discounts applied by the appraiser are justified solely on the restrictions in the partnership agreement, without comparison to terms in similar arm's length transactions. In addition, the numerous studies on discounts for lack of control and lack of marketability are often cited, but consultants draw vague, if any, comparisons of the subject interest to the averages found in the studies [see *Charles T McCord, et ux v. Commissioner*, 120 TC 358 (2003)]. Although the averages in the studies may be used as a starting point, consultants should determine what, if any, adjustments to the averages are necessary based on the subject FLP interest and thoroughly explain this logic in the valuation report. Ultimately, both the discount for lack of control and the discount for lack of marketability require an appraiser's objective support by demonstrating that the application of a discount increases the rate of return to the investor to offset the risks of lack of control and lack of marketability. Several U.S.

> Tax Court cases,such as *Estate of Norman L. Bell v. Commissioner* [TC Memo 1987-576 (1987)] and *Nancy N. Mooneyham v. Commissioner* [TC Memo 1991-178 (1991)], discuss the importance of supporting discounts with applicable evidence.[4]

A more recent case is that of *Estate of Natale B. Giustina v. Commissioner*. This case was originally heard in the Tax Court (T.C. Memo 2011-141) and was ultimately overturned and remanded back to the Tax Court by the 9th Circuit Court of Appeals in 2014 (No. 12-71747). A summary of these cases follows:

At the time of his death, the decedent owned a 41.128 percent interest in Giustina Land and Timber Company Limited Partnership. The estate reported the value of his interest at $12,678,117 on the estate's tax return, and the Tax Court determined the value to be $27,454,115.

The decedent's expert used an asset-based approach as well as an income approach. In its final decision, the Tax Court put 25 percent of the weighting on the asset-based approach because it believed that there was only a 25 percent likelihood that the assets would be sold. The remainder of the value was based on the discounted cash flow method (going concern).

On appeal, the Ninth Circuit reviewed the Tax Court's determinations for "clear error." It first looked at the weighting of the methodologies that was used to determine the value and concluded that the Tax Court's weighting of 25 percent on the asset-based approach was incorrect. The Ninth Circuit stated the following:

> Although the Tax Court recognized that the owner of the limited interest could not unilaterally force liquidation, it concluded that the owner of that interest could form a two-thirds voting bloc with other limited partners to do so, and assigned a 25% probability to this occurrence. This conclusion is contrary to the evidence in the record. In order for liquidation to occur, we must assume that (1) a hypothetical buyer would somehow obtain admission as a limited partner from the general partners, who have repeatedly emphasized the importance that they place upon continued operation of the partnership; (2) the buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest." Alternatively, we must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution. We conclude that it was clear error to assign a 25% likelihood to these hypothetical events.

The court went on to state, "the Tax Court engaged in 'imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect' with the existing partners. We therefore remand to the Tax Court to recalculate the value of the Estate based on the partnership's value as a going concern."

Asset-Based Approach

Obtain the fair market values of all assets and liabilities on the balance sheet and apply appropriate discounts (for lack of control and marketability).

Income Approach

Determine cash flow available to partners and capitalize or discount as appropriate.[5] If a sale of the underlying assets is contemplated, the sales price might be the applicable terminal value. Apply discount for lack of marketability in most cases (no discount for lack of control necessary because cash flow capitalized or discounted is the amount available to the minority owner and, therefore, the result is a minority value).

4 Jay E. Fishman *et. al., PPC's Guide to Business Valuations*, 26th ed. (Fort Worth, TX: Thomson Practitioners Publishing Company, 2016): 14–15.

5 Sources of rates of return include *The Wall Street Journal*, Morningstar, and the National Association of Real Estate Investment Trusts (NAREIT).

Market Approach

Determine valuation multiples by looking for comparable publicly traded interests. The appropriate multiple could be price to dividends, adjusted for the risks associated with your specific valuation assignment.[6] Because this data is based on dividends or distributions to the minority interests, the result is a minority value. Therefore, only a discount for lack of marketability needs to be applied.

Valuation Adjustments

Valuation adjustments are supposed to reflect the lack of control inherent in limited partnership interests and the lack of marketability any type of closely held partnership interest endures. These are two separate issues that usually result in two separate adjustments. The courts recognize the necessity for these discounts but often disagree about how much of a discount should be allowed.

Fair market value is determined by the nature of the interest transferred. Unless the partners agree to admit the transferred interest as a partner, it is an *assignee interest*. Therefore, the hypothetical willing buyer might consider whether or not the other partners would admit him or her as a partner with all the rights that go with being a partner as significant.

An assignee interest has only an economic interest in the partnership. That is, he or she has a right to receive distributions, if any, and a right to distributions on liquidation. An assignee interest has fewer rights than a limited partner.

A limited partner, like a minority shareholder, does not have the ability to "get at" the partnership assets to either manage them or dispose of them. A limited partner probably has little or no say in partnership management issues. And, like a minority shareholder, a limited partner does not control distributions. These are all prerogatives of management or, in the case of the limited partnership, the general partner or the general partner who has been designated as the managing partner.

The hypothetical willing buyer most likely would not pay a liquidation price (pro rata of the underlying assets) for a limited partner or assignee interest in a limited partnership. What a willing buyer would pay would be something less than liquidation value in order to receive a return on his or her investment. This is the basis for valuation adjustments or discounts.

The valuation analyst must read the partnership agreement carefully to determine what the rights and duties of both types of partners are. The voting rights of the limited partners should be determined. These are the types of things that will help to support the size of the discount for lack of control.

Discount for Lack of Control

Although I provided you with some of this stuff in chapter 14, it is important enough to repeat. The types of assets owned by the partnership must be considered when finding a starting point for this discount. As previously discussed, the valuation analyst may not need a discount for lack of control if he or she uses an income or market approach for this type of assignment. Although an FLP could hold almost any type of asset, most FLPs own either marketable securities, real estate, or some combination of both.

Marketable Securities

A logical reference point when valuing an interest in such an FLP is a closed-end investment fund. It is best to use closed-end investment funds that hold publicly traded securities that are similar to the securities held by the FLP, such as domestic stocks, foreign stocks, specialty funds, corporate bonds, municipal bonds, or government bonds. There are many other types of funds.

6 Sources for comparable (guideline) data are Closed End Mutual Funds (*The Wall Street Journal* and Morningstar) and *Direct Investment Spectrum* (published by Partnership Profiles Inc.).

Typically, these funds trade at discounts to their net asset values (NAVs). Statistical efforts to determine a definitive explanation for these discounts have failed to reveal a reason for the discounts. In any event, the discounts (and premiums) observed in the marketplace serve as a proxy for the lack of control discount. The reason that they serve as a proxy is that holders of closed-end funds have the same lack of control over the underlying assets that a limited partner in an FLP has. It is presumed that these discounts represent the market's decrease in value for not having access to the assets and not having any control over them.

Whether the valuation analyst adjusts these discounts before applying them to his or her FLP interest is a question of specific facts and circumstances of the particular valuation assignment. If the valuation analyst believes that the interest he or she is valuing has less control, then he or she might increase the discount, and vice versa. Another issue relates to the similarities of the portfolios. The valuation analyst might believe that his or her subject portfolio would trade at a higher or lower discount. Whatever position the valuation analyst takes, the discussion should include all the reasoning behind the adjustments. However, there is at least one Tax Court case that frowned on changing the size of the discount because there was no empirical evidence to support the adjustment.[7]

This discount only pertains to the issue of lack of control. It has nothing to do with marketability factors. The perceived riskiness of any individual security in the FLP's portfolio will be reflected in the market value of that-security. Any adjustments the valuation analyst might be tempted to make because the partnership interest is not as easily traded as a share in a closed-end mutual fund should be avoided. That is a different discount.

There are several factors (see box 21.5) that might be considered when adjusting the starting point for the discount for lack of control. Remember that adjustments should be reasonable and reflect the facts of the particular FLP interests.

BOX 21.5 **Discount for Lack of Control Adjustment Considerations**

Professional management. Many FLPs do not have professional management, whereas closed-end funds do. This would drive the discount higher.

Regulation. Closed-end funds are regulated by the SEC; the FLP investor enjoys no such protection.

Diversification and size. The FLP portfolio may not have the same level of diversification as a closed-end fund. One can look at specialized funds that invest in one industry as a comparison. FLPs are often very tiny compared to closed-end funds. This might increase the discount.

Investment objective. An FLP portfolio may reflect no defined investment policy or objectives. This may be a lack of professional management.

Quality. Speculative versus investment grade. Recall, however, that the security's market price should reflect the market's opinion about its overall quality. Avoid double counting in the discount.

Performance. If the FLP has been in existence for a while, its total return might be compared with that of various similar closed-end funds.

Average maturity. For fixed income portfolios, average maturity of the bonds will affect their market values. Again, this factor should be addressed in the price of the security.

Real Estate

Very often, an FLP will hold one or more pieces of real property. These might range from the family home to vacation property, vacant land, a farm, or some income-producing real property, such as apartments, retail, or office space. The valuation analyst should review these assets carefully in order to determine the nature of each because this will affect the selection of discounts.

7 See *Peter S. Peracchio v. Commissioner*, T.C. Memo 2003-280.

A starting point for determining lack of control discounts for FLPs owning real estate would be real estate limited partnerships (RELPs) and real estate investment trusts (REITs). These partnerships have been in existence for a number of years and a body of data has been accumulated on many aspects of them. A fairly liquid secondary market for RELPs exists. It is nowhere near as liquid as a stock exchange, but enough transactions take place that there is good data on the discounts at which these securities trade to their NAVs.

Data on this market has been gathered by Partnership Profiles, Inc., since 1990.

Partnership Profiles makes its data available through its Minority Interest Database, which is available by subscription at www.partnershipprofiles.com.In addition, annually, the company publishes an executive summary entitled, xxxx[8] *Executive Summary Report on Partnership Re-Sale Discounts, Special Addendum Covering Real Estate Programs in Executive Summary Report*. This report contains information about some of the partnerships that Partnership Profiles follows, along with information regarding historic summary discounts.

The factors outlined in box 21.6 can influence the price of a RELP in the secondary market. These factors can be considered by the analyst in determining a value for the FLP interest.

According to Partnership Profiles, Inc., the discount derived using this data is primarily a discount for lack of control but also includes some discount for lack of marketability. Be careful not to double count!

Whether or not an FLP has a history of making distributions is an important consideration in determining the discount. Generally, partnerships that make distributions trade at lower discounts to their NAVs, all other things being equal. The amount of debt is important as well. If the FLP that is being valued has no debt, it should be compared to partnerships that have little or no debt, as well.

BOX 21.6 RELP Factors for Valuation Consideration

1. The type of real estate assets owned by the partnership
2. The amount of financial leverage inherent in the partnership's capital structure
3. Underlying cash flow coverage of yearly distributions made to partners
4. The caliber of the information flow from the partnership and the general partner
5. Whether or not the assets of the partnership are well-diversified
6. The reputation, integrity, and perceived competence of the management and general partner
7. Liquidity factors such as how often a partnership interest trades, the number of investors in the partnership, the time period until liquidation, the universe of interested buyers, whether the partnership is publicly or privately syndicated, and the presence of rights of first refusal

Consider as many comparable partnerships from this study as possible. Courts have maintained that more comparables are better than fewer, and certainly better than only one.

As with a discount obtained using closed-end funds, this discount for real estate limited partnerships is also a starting point. It may be adjusted— either upward or downward—by factors that differentiate the FLP being valued from the comparable real estate limited partnership. These are similar to the ones enumerated under the marketable securities section.

Discount for Lack of Marketability

An additional adjustment is often made to account for the fact that there is no secondary market for FLP interests. These interests lack marketability, that is, they cannot be liquidated or converted to cash quickly. If one owns shares of a publicly traded corporation, one may call a broker, sell the shares, and have the cash proceeds within a few business days. Not so with FLP interests, and this is the basis for the discount for lack of marketability (DLOM). In addition to the lack of a secondary market for FLP interests, certain provisions are often written into FLP agreements restricting the transfer of interests, especially to individuals or entities outside of the family circle. These restrictions create an additional lack of marketability factor. Some of them include the following:

8 xxxx = year of study.

- With some exceptions, a general partner, limited partner, or an assignee may not transfer all or any part of his or her interest without the prior written consent of the general partners, which consent may be given or withheld at the discretion of the general partners.
- A transferee of an interest in an FLP shall only be entitled to the rights of an assignee unless the consent of all general partners and a majority in interest of the limited partners is given to make the transferee a substitute limited partner.
- No partner or assignee shall have the right to withdraw from the FLP prior to its dissolution and liquidation.
- No partner or assignee may withdraw or reduce his or her capital contribution or capital account without the consent of the general partner.

Other Provisions Affecting Marketability

In addition to provisions in the agreement that restrict transfer, a history of little or no dividends or distributions from the FLP to the partners is a factor that affects marketability. A willing buyer might be more inclined to ignore restrictions on the transfer of his or her interest in exchange for a stream of cash benefits. However, little or no distribution history is common with FLPs, which often retain income and gains in order to fulfill the long-term investment goals of the partnership.

Another factor that might affect the marketability of an FLP interest is the *754 election*. This is an election that the partnership might make under IRC Section 754, which provides that the partnership may elect to adjust the inside basis of the partnership's underlying assets. In other words, the partnership can adjust its internal books to show that a new partner paid a higher price for assets that are worth more at the time of the purchase (transfer). This election would not affect the existing partners, but it would have positive tax consequences for a new partner.

If there is nothing in the agreement that addresses the 754 election, it does not mean that the partnership cannot make the election. It still can. However, a willing buyer might wish to have assurance that such an election will be made. This is especially critical if the fair market value of the underlying assets of the partnership have increased in value over their original basis. Because there is considerable record keeping involved once this election is made, an FLP may be reluctant to make the election. However, there is at least one Tax Court case[9] that expressed skepticism when the valuation analyst increased the discount because there was nothing in the agreement guaranteeing that the election would be made. The judge stated that he did not believe that a transaction would take place without the guarantee of a 754 election. However, I've seen many partnership tax returns in which a transfer of an interest takes place without a corresponding election!

When valuing a general partner interest, some consideration may be given to an additional marketability factor reflecting the liability exposure assumed by the general partner and that under many states' partnership statutes, a majority of the limited partners may remove a general partner that assigns all the general partner's interest in an FLP to a third party. Here, the valuation analyst must read the partnership agreement carefully to determine under what circumstances a general partner interest may be transferred or whether, after withdrawal of a general partner, that general partner interest becomes a limited partner interest. In this case, the DLOM might be increased.

An FLP can require additional capital from the partners in order to meet operating expenses and have extra capital for partnership requirements. This type of provision is not included in every FLP agreement, but its presence may warrant an additional lack of marketability factor. Capital calls might require that an interest-holder remain liquid in order to meet them, rather than place funds in a higher yielding, but less liquid, investment. A willing buyer would give this additional liability exposure and potential loss of a more favorable investment rate of interest consideration in determining value and so does the valuation analyst when valuing the interest in the FLP.

9 See *Estate of W.W. Jones II v. Commissioner*, 116 TC 121.

Sources of Marketability Discounts

The sources for discounts for lack of marketability for FLP assignments are the same as for all valuation assignments and were discussed in detail in chapter 15. The valuation analyst starts with the restricted stock and pre-initial public offering studies and the quantitative models and then addresses the facts and circumstances of the specific valuation assignment to determine the adjustments to the discount that will be utilized in the assignment at hand. There are several lists of factors to consider that have been published. The first list can be found in box 21.7, which comes from *PPC's Guide to Business Valuations* (pages 14–41 and 42).

The second list comes from an article published by Robert E. Moroney titled, "Why 25% Discount for Nonmarketability in One Valuation, 100% in Another?" I presented this stuff in chapter 15.

BOX 21.7 Marketability Discount Factors

Some of the factors that would cause an interest to trade at a low marketability discount include the following:

- Minimal volatility in the value of the underlying assets
- Above-average expectations for future yield
- A proven and stabilized history of income
- Certainty of distributions or expectation of capital appreciation
- Limited time period on restriction of ability to sell the interest
- Favorable outlook for future growth of the entity
- Imminent prospect of liquidation of the partnership

Factors that would cause an interest to trade at a higher discount include the following:

- High degree of volatility in the value of the underlying assets
- Questionable ability to generate a satisfactory return on assets
- Inability to generate sufficient earnings for distributions or to support future growth in operations
- Small size in relation to other investments and lack of diversification
- Involvement in industries or activities viewed unfavorably by the investing public

Other Potential Adjustments

There are several other adjustments that may be included in determining a final value. Some of these adjustments may apply to the value of the underlying assets, rather than to the value of an FLP interest. Some of these discounts are discussed in more detail in other chapters in this book.

Fractional Interest Adjustment

The fair market value of an undivided ownership interest in real property is worth something less than the percentage of ownership multiplied by the fair market value of the real property as a whole. Fractional interest adjustments should not be limited to undivided interests in real property, but should be considered any time a fractional interest is held in any type of property. Some of the factors considered by the willing buyer at arriving at a fractional interest adjustment are the following:

- Lack of control associated with a minority interest in the property
- Lack of marketability of a fractional interest
- Procedural burdens, possible delays, and costs involved in severance proceedings
- Lack of certainty about what portion of the property would be awarded to each party upon severance
- The nature of the property
- The difficulty of obtaining mortgage financing for the purchase of a fractional interest
- Declining economic conditions
- Loss of a major tenant

Most real estate appraisers will not apply these fractional interest discounts. However, the valuation analyst should check the real estate appraisal, if there is one, to see if this has already been done, in order to avoid double discounting. See *Ludwick v. Commissioner*, TC Memo 2010-104.

A recent case approved a fractional interest discount in artwork. See *Estate of Elkins v. Commissioner*, 140 TC 86 (March 11, 2013) reaffirmed by the 5th Circuit Court of Appeals (No. 60683, September 15, 2014). In this case, a discount of 10 percent was allowed by the Court, but the 5th Circuit ruled that this “nominal” amount was not enough and the appropriate discount was 44.75 percent.

Portfolio Adjustment

The basis for a portfolio adjustment is an FLP with a non-diversified portfolio of marketable securities. In applying a willing buyer/willing seller test, the valuation analyst must decide if a willing buyer might not be interested in a portfolio with a specific asset mix, rather than a diversified portfolio. A portfolio containing one or two holdings might be considered riskier than one that was well-diversified. See *Estate of Piper v. Commissioner*, 72 TC 1062 (Sept. 13, 1979).

Restricted Securities Adjustment

Restricted securities are those that are acquired from an issuer in a transaction exempt from registration requirements of federal and state securities laws (known as *private placements*). There are also restrictions imposed by the SEC on resales of these restricted securities. Several court cases have upheld additional discounts to account for restricted securities, but if the price of the security already reflects such a discount, it should not be taken twice.

Blockage Adjustment

This adjustment accounts for the depressive effect of suddenly placing a large block of stock on the market. This adjustment is expressly recognized by Treasury Regulation Sections 20.2031-2(e) and 25.2512-2(e). Adjustments of this type are limited to blocks of publicly traded stock. It is helpful to fully document trading and volume activity in a stock for a period of time prior to the valuation date in order to justify such an adjustment.

Market Absorption Adjustment

This is an expansion of the blockage adjustment to take into account other assets besides stock, such as real estate, works of art, sheet music, manuscripts, books, animal mounts, and animal trophies. The basis of this adjustment reflects the lack of time within which to make an orderly disposition of these types of assets. It is possible that the sale of all the property at once or within a short space of time might result in an abrupt increase in supply, which, with no change in demand, might reduce the price the properties might bring. The valuation analyst should consider the number and type of asset being considered and whether or not such an adjustment has been included in any professional valuation of these assets.

Adjustment for Built-In Capital Gains Tax

Under the willing buyer/willing seller test, an adjustment may be made for the fact that the underlying assets may now have a market value greater than book value and there may be a built-in capital gain with respect to those assets. If so, a willing buyer might become responsible for capital gains tax when the assets are sold. A hypothetical willing buyer would take this into consideration when evaluating an FLP interest. This issue is also related to the IRC Section 754 election.

The FLP Written Report

Now that there are issues to consider, how does the valuation analyst go about presenting these findings in the report? One useful way is to set up the report following the eight factors of Revenue Ruling 59-60. Remember, the ultimate user of the report is the IRS. By laying out the report in the order of the eight factors, the valuation analyst is showing the IRS that he or she is considering each of the factors that they have laid out in their ruling. In addition, the valuation analyst should include sections relating to capitalization and discount rates, if appropriate, as well as discounts and premiums.

The valuation analyst might also want to consider following the IRS’s adequate disclosure rules as laid out in Regulation Section 301.6501. These have been included as exhibit 21.1. Although these regulations specifically relate to gifts, including the same information in a report for estate tax purposes will aid the valuation analyst in preparing a well-supported report.

EXHIBIT 21.1 IRS Adequate Disclosure Rules

REG Section 301.6501(c)-1. Exceptions to general period of limitations on assessment and collection.

Caution: The Treasury has not yet amended Regulation Section 301.6501(c)-1 to reflect changes made by PL 105-34.

301.6501(c)-1(a) False return. In the case of a false or fraudulent return with intent to evade any tax, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time after such false or fraudulent return is filed.

301.6501(c)-1(b) Willful attempt to evade tax. In the case of a willful attempt in any manner to defeat or evade any tax imposed by the Code (other than a tax imposed by subtitle A or B, relating to income, estate, or gift taxes), the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time.

301.6501(c)-1(c) No return. In the case of a failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time after the date prescribed for filing the return. For special rules relating to filing a return for Chapter 42 and similar taxes, see §301.6501(n)-1, 301.6501(n)-2, and 301.6501(n)-3.

301.6501(c)-1(d) Extension by agreement. The time prescribed by section 6501 for the assessment of any tax (other than the estate tax imposed by Chapter 11 of the Code) may, prior to the expiration of such time, be extended for any period of time agreed upon in writing by the taxpayer and the district director or an assistant regional commissioner. The extension shall become effective when the agreement has been executed by both parties. The period agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

301.6501(c)-1(e) Gifts subject to Chapter 14 of the Internal Revenue Code not adequately disclosed on the return.

301.6501(c)-1(e)(1) In general. If any transfer of property subject to the special valuation rules of section 2701 or section 2702, or if the occurrence of any taxable event described in section 25.2701-4 of this Chapter, is not adequately shown on a return of tax imposed by Chapter 12 of subtitle B of the Internal Revenue Code (without regard to section 2503(b)), any tax imposed by Chapter 12 of subtitle B of the Code on the transfer or resulting from the taxable event may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time.

301.6501(c)-1(e)(2) Adequately shown. A transfer of property valued under the rules of section 2701 or section 2702 or any taxable event described in §25.2701-4 of this Chapter will be considered adequately shown on a return of tax imposed by Chapter 12 of subtitle B of the Internal Revenue Code only if, with respect to the entire transaction of series of transactions (including any transaction that affected the transferred interest) of which the transfer (or taxable event) was a part, the return provides:

301.6501(c)-1(e)(2)(i) A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;

301.6501(c)-1(e)(2)(ii) The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transactions; and

301.6501(c)-1(e)(2)(iii) A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the 5 years immediately before the valuation date.

301.6501(c)-1(e)(3) Effective date. The provisions of this paragraph (e) are effective as of January 28, 1992. In determining whether a transfer or taxable event is adequately shown on a gift tax return filed prior to that date, taxpayers may rely on any reasonable interpretation of the statutory provisions. For these purposes, the provisions of the proposed regulations and the final regulations are considered a reasonable interpretation of the statutory provisions.

301.6501(c)-1(f) Gifts made after December 31, 1996, not adequately disclosed on the return.

301.6501(c)-1(f)(1) In general. If a transfer of property, other than a transfer described in paragraph (e) of this section, is not adequately disclosed on a gift tax return(Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return"), or in a statement attached to the return, filed for the calendar period in which the transfer occurs, then any gift tax imposed by Chapter 12 of subtitle B of the Internal Revenue Code on the transfer may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time.

EXHIBIT 21.1 IRS Adequate Disclosure Rules

301.6501(c)-1(f)(2) Adequate disclosure of transfers of property reported as gifts. A transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported. Transfers reported on the gift tax return as transfers of property by gift will be considered adequately disclosed under this paragraph (f)(2) if the return (or a statement attached to the return) provides the following information—

301.6501(c)-1(f)(2)(i) A description of the transferred property and any consideration received by the transferor;

301.6501(c)-1(f)(2)(ii) The identity of, and relationship between, the transferor and each transferee;

301.6501(c)-1(f)(2)(iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

301.6501(c)-1(f)(2)(iv) Except as provided in §301.6501-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. In the case of a transfer of an interest that is actively traded on an established exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ National Market, or a regional exchange in which quotations are published on a daily basis, including recognized foreign exchanges, recitation of the exchange where the interest is listed, the CUSIP number of the security, and the mean between the highest and lowest quoted selling prices on the applicable valuation date will satisfy all of the requirements of this paragraph (f)(2)(iv). In the case of the transfer of an interest in an entity (for example, a corporation or partnership) that is not actively traded, a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity. In addition, if the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, a statement must be provided regarding the fair market value of 100 percent of the entity (determined without regard to any discounts in valuing the entity or any assets owned by the entity), the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred interest as reported on the return. If 100 percent of the value of the entity is not disclosed, the taxpayer bears the burden of demonstrating that the fair market value of the entity is properly determined by a method other than a method based on the net value of the assets held by the entity. If the entity that is the subject of the transfer owns an interest in another non-actively traded entity (either directly or through ownership of an entity), the information required in this paragraph (f)(2)(iv) must be provided for each entity if the information is relevant and material in determining the value of the interest; and

301.6501(c)-1(f)(2)(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer (see §601.601(d)(2) of this Chapter).

301.6501(c)-1(f)(3) Submission of appraisals in lieu of the information required under paragraph (f)(2)(iv) of this section. The requirements of paragraph (f)(2)(iv) of this section will be satisfied if the donor submits an appraisal of the transferred property that meets the following requirements—

301.6501(c)-1(f)(3)(i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:

301.6501(c)-1(f)(3)(i)(A) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis.

301.6501(c)-1(f)(3)(i)(B) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued.

301.6501(c)-1(f)(3)(i)(C) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, as defined in section 2032A(e)(2), or any person employed by the donor, the donee, or a member of the family of either; and

301.6501(c)-1(f)(3)(ii) The appraisal contains all of the following:

301.6501(c)-1(f)(3)(ii)(A) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.

(continued)

EXHIBIT 21.1 IRS Adequate Disclosure Rules *(continued)*

301.6501(c)-1(f)(3)(ii)(B) A description of the property.

301.6501(c)-1(f)(3)(ii)(C) A description of the appraisal process employed.

301.6501(c)-1(f)(3)(ii)(D) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions.

301.6501(c)-1(f)(3)(ii)(E) The information considered in determining the appraised value, including in the case of an ownership interest in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value.

301.6501(c)-1(f)(3)(ii)(F) The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions.

301.6501(c)-1(f)(3)(ii)(G) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred.

301.6501(c)-1(f)(3)(ii)(H) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

301.6501(c)-1(f)(4) Adequate disclosure of non-gift completed transfers or transactions. Completed transfers to members of the transferor's family, as defined in section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be adequately disclosed under paragraph (f)(2) of this section, even if the transfer is not reported on a gift tax return, provided the transfer is properly reported by all parties for income tax purposes.

For example, in the case of salary paid to a family member employed in a family owned business, the transfer will be treated as adequately disclosed for gift tax purposes if the item is properly reported by the business and the family member on their income tax returns. For purposes of this paragraph (f)(4), any other completed transfer that is reported, in its entirety, as not constituting a transfer by gift will be considered adequately disclosed under paragraph (f)(2) of this section only if the following information is provided on, or attached to, the return B 301.6501(c)-1(f)(4)(i) The information required for adequate disclosure under paragraphs (f)(2)(i), (ii), (iii) and (v) of this section; and

301.6501(c)-1(f)(4)(ii) An explanation as to why the transfer is not a transfer by gift under Chapter 12 of the Internal Revenue Code.

301.6501(c)-1(f)(5) Adequate disclosure of incomplete transfers. Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer, even if the transfer is ultimately determined to be an incomplete gift for purposes of §25.2511-2 of this Chapter. For example, if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed, as determined under section 6501(b). Further, once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included. On the other hand, if the transfer is reported as an incomplete gift whether or not adequately disclosed, the period for assessing a gift tax with respect to the transfer will not commence to run even if the transfer is ultimately determined to be a completed gift. In that situation, the gift tax with respect to the transfer may be assessed at any time, up until three years after the donor files a return reporting the transfer as a completed gift with adequate disclosure.

301.6501(c)-1(f)(6) Treatment of split gifts. If a husband and wife elect under section 2513 to treat a gift made to a third party as made one-half by each spouse, the requirements of this paragraph (f) will be satisfied with respect to the gift deemed made by the consenting spouse if the return filed by the donor spouse (the spouse that transferred the property) satisfies the requirements of this paragraph (f) with respect to that gift.

301.6501(c)-1(f)(7) Examples. The following examples illustrate the rules of this paragraph (f):

Example (1). (i) Facts. In 2001, A transfers 100 shares of common stock of XYZ Corporation to A's child. The common stock of XYZ Corporation is actively traded on a major stock exchange. For gift tax purposes, the fair market value of one share of XYZ common stock on the date of the transfer, determined in accordance with §25.2512-2(b) of this Chapter (based on the mean between the highest and lowest quoted selling prices), is $150.00. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A reports the gift to A's child of 100 shares of common stock of XYZ Corporation with a value for gift tax purposes of $15,000. A specifies the date of the transfer, recites that the stock is publicly traded, identifies the stock exchange on which the stock is traded, lists the stock's CUSIP number, and lists the mean between the highest and lowest quoted selling prices for the date of transfer.

EXHIBIT 21.1 IRS Adequate Disclosure Rules

(ii) Application of the adequate disclosure standard. A has adequately disclosed the transfer. Therefore, the period of assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b)).

Example (2). (i) Facts. On December 30, 2001, A transfers closely-held stock to B, A's child. A determined that the value of the transferred stock, on December 30, 2001, was $9,000. A made no other transfers to B, or any other donee, during 2001. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A provides the information require under paragraph (f)(2) of this section such that the transfer is adequately disclosed. A claims an annual exclusion under section 2503(b) for the transfer.

(ii) Application of the adequate disclosure standard. Because the transfer is adequately disclosed under paragraph (f)(2) of this section, the period of assessment for the transfer will expire as prescribed by section 6501(b), notwithstanding that if A's valuation of the closely-held stock was correct, A was not required to file a gift tax return reporting the transfer under section 6019. After the period of assessment has expired on the transfer, the Internal Revenue Service is precluded from redetermining the amount of the gift for purposes of assessing gift tax or for purposes of determining the estate tax liability. Therefore, the amount of the gift as reported on A's 2001 Federal gift tax return may not be redetermined for purposes of determining A's prior taxable gifts (for gift tax purposes) or A's adjusted taxable gifts (for estate tax purposes).

Example (3). (i) Facts. A owns 100 percent of the common stock of X, a closely-held corporation. X does not hold an interest in any other entity that is not actively traded. In 2001, A transfers 20 percent of the X stock to B and C, A's children, in a transfer that is not subject to the special valuation rules of section 2701. The transfer is made outright with no restrictions on ownership rights, including voting rights and the right to transfer the stock. Based on generally applicable valuation principles, the value of X would be determined based on the net value of the assets owned by X. The reported value of the transferred stock incorporates the use of minority discounts and lack of marketability discounts. No other discounts were used in arriving at the fair market value of the transferred stock or any assets owned by X. On A's Federal gift tax return, Form 709, for the 2001 calendar year, A provides the information required under paragraph (f)(2) of this section including a statement reporting the fair market value of 100 percentof X (before taking into account any discounts), the pro rata portion of X subject to the transfer, and the reported value of the transfer. A also attaches a statement regarding the determination of value that includes a discussion of the discounts claimed and how the discounts were determined.

(ii) Application of the adequate disclosure standard. A has provided sufficient information such that the transfer will be considered adequately disclosed and the period of assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b)).

Example (4). (i) Facts. A owns a 70 percent limited partnership interest in PS. PS owns 40 percent of the stock in X, a closely-held corporation. The assets of X include a 50 percent general partnership interest in PB. PB owns an interest in commercial real property. None of the entities (PS, X, or PB) is actively traded and, based on generally applicable valuation principles, the value of each entity would be determined based on the net value of the assets owned by each entity. In 2001, A transfers a 25 percent limited partnership interest in PS to B, A's child. On the Federal gift tax return, Form 709, for the 2001 calendar year, A reports the transfer of the 25 percent limited partnership interest in PS and that the fair market value of 100 percent of PS is $y and that the value of 25 percent of PS is $z, reflecting marketability and minority discounts with respect to the 25 percent interest.However, A does not disclose that PS owns 40 percent of X, and that X owns 50 percent of PB and that, in arriving at the $y fair market value of 100 percent of PS, discounts were claimed in valuing PS's interest in X, X's interest in PB, and PB's interest in the commercial real property.

(ii) Application of the adequate disclosure standard. The information on the lower tiered entities is relevant and material in determining the value of the transferred interest in PS. Accordingly, because A has failed to comply with requirements of paragraph (f)(2)(iv) of this section regarding PS's interest in X, X's interest in PB, and PB's interest in the commercial real property, the transfer will not be considered adequately disclosed and the period of assessment for the transfer under section 6501 will remain open indefinitely.

Example (5). The facts are the same as in Example 4 except that A submits, with the Federal tax return, an appraisal of the 25 percent limited partnership interest in PS that satisfies the requirements of paragraph (f)(3) of this section in lieu of the information required in paragraph (f)(2)(iv) of this section. Assuming the other requirements of paragraph (f)(2) of this section are satisfied, the transfer is considered adequately disclosed and the period for assessment for the transfer under section 6501 will run from the time the return is filed (as determined under section 6501(b) of this Chapter).

(continued)

EXHIBIT 21.1 IRS Adequate Disclosure Rules *(continued)*

Example (6). A owns 100 percent of the stock of X Corporation, a company actively engaged in a manufacturing business. B, A's child, is an employee of X and receives an annual salary paid in the ordinary course of operating X Corporation. B reports the annual salary as income on B's income tax returns. In 2001, A transfers property to family members and files a Federal gift tax return reporting the transfers. However, A does not disclose the 2001 salary payments made to B. Because the salary payments were reported as income on B's income tax return, the salary payments are deemed to be adequately disclosed. The transfer of property to family members, other than the salary payments to B, reported on the gift tax return must satisfy the adequate disclosure requirements under paragraph (f)(2) of this section in order for the period of assessment under section 6501 to commence to run with respect to those transfers.

301.6501(c)-1(f)(8) Effective date. This paragraph (f) is applicable to gifts made after December 31, 1996, for which the gift tax return for such calendar year is filed after December 3, 1999.

Essentially, the IRS is telling the valuation analyst that to "pass muster," we must present a fully supported and documented report. This is not substantially different from all the standards discussed earlier in this book: Do the work and report it properly.

The valuation analyst should not have the reader of the report have to guess about his or her methodology, discounts, or conclusions. For example, the valuation analyst does not want to state: "the studies indicate 25 to 45 percent; therefore, we selected 35 percent." This is not supported. There are numerous court cases that disallow discounts strictly because the valuation analyst did something similar to this. The valuation analyst should select a benchmark discount and then adjust it (up or down) based on specific items that he or she discussed in detail in the report and, if necessary, use quantitative methods along with the other studies. A sample FLP report is located in cyberspace for download with all of the other goodies that come with this book.

As Valuation Analysts, Do We Go for the Big Discounts?

You should now have a better idea about our role as valuation analysts. It is important that the valuation analyst not cross the line from being an independent, objective valuation analyst to being an advocate of bigger and bigger discounts. This can happen, especially if a client requests that we review a partnership document with an eye to adding restrictions and provisions that might increase the discounts. This is not our role as valuation analysts because we must be unbiased and not lose our objectivity. In addition, by acquiescing in such requests, we move beyond the realm of our own expertise. This does not excuse valuation analysts from being aware of the law, especially state laws regarding limited partnerships and LLCs. Key questions to review with the partnership's attorney might include the following:

- What restrictions in the partnership documents are more restrictive than state law?
- What is the state law? Get a copy of the state's Limited Partnership Act and read it thoroughly.
- Does a limited partner have a right of withdrawal from the partnership and on what basis?

As we have seen, these issues can affect the valuation conclusion. It is important for the valuation analyst to remember that his or her assignment is the determination of fair market value. This means the consideration of both a hypothetical willing buyer as well as a hypothetical willing seller. The valuation analyst's final conclusion of value must be reasonable. Remember, the buyer might buy for that low a price, but an independent analyst must also ask the question, if I were the seller, would I sell that low?

Conclusion

In addition to the valuation of interests in FLPs for estate and gift tax purposes, the valuation analyst will also value operating entities. The issues that were discussed in earlier chapters in this book regarding valuation are applicable for estate and gift tax valuations as well. The IRS also looks at issues such as built in gains (chapter 14), pass-through entity tax affecting (chapter 18), quantification and support of normalization adjustments (chapter 6), and quantification and support of discounts and premiums (chapters 14 and 15). This is in addition to the proper application of the various valuation approaches and methods, as well as the quantification and support of discount and capitalization rates (chapter 13). This book is definitely worth it.

If I have done my job, there should now be a much better understanding of estate and gift tax valuations and recognition that the valuation analyst deals with many of the same issues in these valuations as he or she does in all other valuations.

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Gary is the chairman of the Constitution and Bylaws Committee, past-chair of the Ethics Committee, past-chair of the Business Valuation Education Subcommittee and a past elected member of the Business Valuation Committee of the American Society of Appraisers. Gary was formerly on the American Institute of CPAs' ABV Examinations Task Force, Subcommittee Working with the Judiciary, ABV Credentials Committee, Executive Committee of the Management Consulting Services Division and the Business Valuation Subcommittee. He is the former chairman of the Florida Institute of CPAs' Litigation, Forensic Accounting and Valuation Services Section and was formerly on the New Jersey Society of CPAs' Litigation Services Committee, Business Valuation Subcommittee (past-chairman) and Matrimonial Committee.

Gary is former chairman of the Ethics and Discipline Committee, and formerly served on the Qualifications Review Committee and is the former regional governor of the Mid-Atlantic Region of The Institute of Business Appraisers Inc. He has received a AFellow@ Award from The Institute of Business Appraisers Inc. for his many years of volunteer work in the profession. Gary has also received an AICPA AHall of Fame@ Award for his service to the accounting profession in assisting in the accreditation in business valuation process. Gary formerly served on the International Board of Examiners of the American Society of Appraisers. He is a faculty member of the National Judicial College, educating judges around the country.

Gary lectures nationally on business valuation topics. He is the author of a textbook entitled *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*, now in its 5th edition, and an e-book entitled *Essentials of Valuing a Closely-Held Business*, both published by the American Institute of CPAs. He also has developed numerous educational courses, including but not limited to, a six-day business valuation educational series and a seminar entitled *Understanding Business Valuation for the Practice of Law* for the Institute of Continuing Legal Education. Gary also serves as an editorial adviser for the *Journal of Accountancy*, *The CPA Expert*, *Business Valuation Update* and formerly for *National Litigation Consultants' Review* and the *CPA Litigation Service Counselor.* He has lectured in front of numerous groups and has been published in the *Journal of Accountancy*, *FairShare* and *The CPA Litigation Service Counselor.*

Gary was born in New York and received his undergraduate degree from The Bernard M. Baruch College of the City University of New York. He was the first business appraiser in the United States to earn a master's in Valuation Sciences from Lindenwood College. His master's thesis topic was "Equitable Distribution Value of Closely Held Businesses and Professional Practices." Gary's appraisal education also includes various courses The Institute of Business Appraisers, the American Society of Appraisers, the American Institute of CPAs and others offer. He has taught federal income taxation at Centenary College, financial statement analysis in the master's degree program at Lindenwood College, and several topics at the AICPA National Tax School in Champaign, Illinois. Gary was an adjunct professor teaching a valuation course at Florida International University. He is a member of The Institute of Business Appraisers Inc., the American Society of Appraisers, the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants.

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