



FLPs in Tax Court

Emphasizing the Discount for Lack of Marketability (DLOM)

Estate Planning Council of St. Louis
December 12, 2022

Weaver at a Glance



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DL0M in U.S. Tax Court FLP Cases

FLP CASES

- ▶ *Knight v. Commissioner*, 115 T.C. No. 36 (2000)
- ▶ *Dailey v. Com.*, T.C. Memo. 2001-263
- ▶ *Jones v. Com.*, 116 TC 121 (T.C. 2001)
- ▶ *McCord v. Com.*, 120 T.C. No. 13 (2003)
- ▶ *Lappo v. Com.*, T.C. Memo. 2003-258
- ▶ *Peracchio v. Com.*, T.C. Memo. 2003-280
- ▶ *Estate of Kelley*, T.C. Memo. 2005-235



DL0M in U.S. Tax Court FLP Cases

CASES CONTINUED

- ▶ *Astleford v. Com.*, T.C. Memo. 2008-128
- ▶ *Holman v. Com.*, 130 T.C. No. 12 (2008)
- ▶ *Estate of Elkins v. Com.*, 140 T.C. No. 5 (2013)*
- ▶ *Estate of Streightoff v. Com.*, T.C. Memo. 2018-178
- ▶ *Grieve v. Com.*, T.C. Memo. 2020-28
- ▶ *Nelson v. Com.*, T.C. Memo. 2020-81

CONTESTED CASES IN FEDERAL DISTRICT COURT

- ▶ *Estate of Murphy v. U.S.*, No. 07-CV-1013 (W.D. Ark. Oct. 2, 2009)
- ▶ *Temple v. U.S.*, 423 F.Supp.2d 605 (E.D.Tex. 2006)

* Not a "FLP" Case

► Why study old cases?

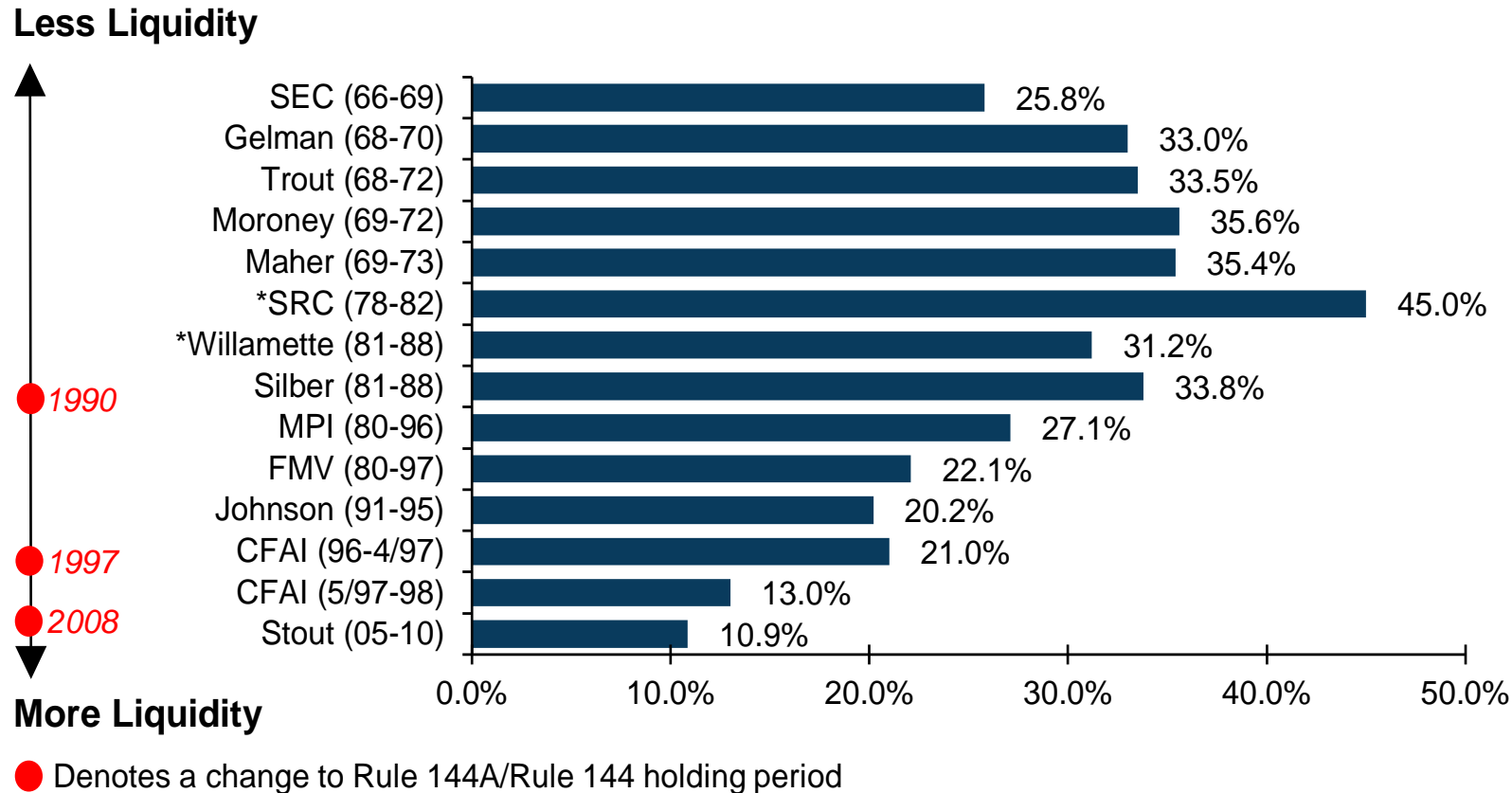
- Tax Court still finds these relevant
- No changes in laws or regulations
- IRS Exams uses cases as a primary valuation tool
- IRS Appeals assesses “hazards of litigation” based on cases
- Get a better settlement
- Be better able to assess your appraiser’s expert report

LITTLE KNOWN FACTS ABOUT FLPS IN TAX COURT

1. There has not been a pure FLP valuation case **since 2005** —17 years (*Kelley*)
 - a) *Grieve* was contested but **unconventionally**
 - b) *Holman* was influenced by **loss of 2703 argument**
 - c) *Astleford-DLOM* influenced by **tiered structure**
2. One Taxpayer's appraiser "won" a contested FLP valuation case (accepted as filed) – *Dailey*
 - a) Judge was **not complimentary** but accepted it in view of his **dislike for the IRS appraisal**
 - b) Discount was a combined one; **no separate DLOM**
3. One IRS appraiser "won" one case – *Holman*
 - a) That same appraiser used the **same argument** in *Peracchio* and lost with the same judge
 - b) The *Holman* valuation argument is **hard to justify**
4. IRS won *Streightoff* but taxpayer's appraiser was instructed to value interest as an **assignee interest**, which the Court rejected.

Summary of Restricted Stock Studies

Discounts for Lack of Marketability



Studies denoted with (*) reflect medians.

Cases with Problems Obscuring the Valuation

Case	Year	Disposition of DLOM	Court's Discount	Comment
Knight	2000	TP rejected for bias; no IRS appraisal	15%	Not thorough and no support for “portfolio discount”
Holman	2008	Describes disconnect; FLP with low risk assets and RSS of risky companies	12.5%	Decision inconsistent with FMV definition
Streightoff	2018	TP's appraisal rejected; based on assignee argument	18%	IRS appraiser's DLOM was on a controlling LP Interest
Astleford	2008	Tiered structure makes comparison difficult	N/A	Description of methodology and Court's reasoning are lacking and confusing
Dailey	2001	IRS rejected; TP begrudgingly accepted	40%	No meaningful discussion provided; how much of discount was DLOM?

TP – taxpayer
RSS – restricted stock studies

DLOM in U.S. Tax Court FLP cases

Cases Highlighting Failure of Valuation or Theory



Case	Year	Disposition of DLOM	Court's Discount	Comment
McCord	2003	Established "traditional" method for marketable FLPs	20%	Rejected: TP older RSS and Pre-IPO method, and IRS use of "Bajaj method". Wanted to quash defined value clause.
Grieve	2020	Accepted as filed; IRS novel theory rejected	25%	Judge struggled with accepting the traditional method.
Lappo	2003	Followed McCord	24%	TP- failed to consider low risk of assets; IRS- Bajaj regression method rejected
Kelley	2005	Followed McCord	23%	TP- failed to consider low risk of assets; IRS- Bajaj regression method rejected.
Peracchio	2003	TP-restricted stock studies and Mandelbaum case	25%	Both TP and IRS experts failed to provide thorough analysis.
Nelson	2020	IRS-restricted stock studies and Quantitative Methods	28%	Tiered discount. 30% DLOM already applied at holding company level.

DL0M in U.S. Tax Court FLP Cases

FAILURE TO ANALYZE

- ▶ “[TP appraiser] **concluded that a 10-percent portfolio discount applies** based on the assumption that it is unlikely that a buyer could be found **who would want to buy all** of the Knight family partnership’s assets. **He provided no evidence to support that assumption.**

KNIGHT V. COMMISSIONER

- ▶ [TP Appraiser] **cited seven studies** of sales of restricted stocks from 1969 to 1984 to support his estimate that a 30-percent discount for lack of marketability applies... However, **he did not show that the companies in the studies or the table were comparable** to the partnership, **or explain how he used this data** to estimate the discount for lack of marketability.

DLOM in U.S. Tax Court FLP Cases

FAILURE TO ANALYZE

- ▶ Petitioners' expert, citing published data, opined that the aggregate discount is 40 percent for lack of marketability, control, and liquidity
- ▶ Respondent's expert's testimony was "contradictory, unsupported by the data, and inapplicable to the facts." Court focused on the fact that the regression analysis was from an unpublished paper and the expert had not read the Dailey partnership agreement.

DAILEY V. COMMISSIONER

- ▶ "Although **neither expert was extraordinary, petitioners' expert provided a more convincing and thorough analysis** than respondent's expert."
- ▶ Note: The Court found the fact that the stock held by the partnership had a very low basis was significant. The taxpayer's expert cited this. The government's expert was unaware of this fact.

LESSONS LEARNED

- ▶ [TP appraiser] failed to convince the Court that the very long holding period of the partnership justified a high discount. The Court focused on the safety of the assets held in deciding on a lower discount.
- ▶ [IRS appraiser] failed to convince the Court that his very low discount determined by regression analysis was valid.

McC0RD V. COMMISSIONER

- ▶ [TP Appraiser] **cited restricted stock studies and Pre-IPO studies in justifying DL0M.** ... The court rejected Pre-IPO studies as a valid measure and stated that more recent restricted stock studies were more relevant.
- ▶ [IRS appraiser] conducted a “private placement” study of 88 recent transactions which the Court found very useful.

MCCORD V. COMMISSIONER (120 T.C. NO. 13)

- ▶ “First, we believe that, given MIL’s status as an investment company, what Dr. Bajaj refers to in the context of private placements as assessment and monitoring costs would be relatively **low** in the case of a sale of an interest in MIL
- ▶ That belief, coupled with Dr. Bajaj’s persuasive argument that such costs are relatively high in unregistered private placements, leads us to conclude that a sample consisting entirely of unregistered private placements would be **inappropriately skewed**
- ▶ Second, only Dr. Bajaj’s study (and not the other private placement studies on which he relies) covers the period (1990-1995) **immediately preceding the valuation date**”

MCCORD V. COMMISSIONER (120 T.C. NO. 13)

► McCord was reversed by the 5th Circuit

1. Formula gift (defined value clause) was reestablished
2. Frazier's valuation reinstated
3. Formula Gift aspect viewed favorably
4. Section 2035 estate tax liability deduction permitted
5. Did not disturb Tax Court's opinion of valuation methodology since decision was *reversed on other grounds*

DL0M in U.S. Tax Court FLP Cases

FAILURE TO ANALYZE

- ▶ Thirteen of the 39 companies in [TP Appraiser's] guideline group appear to be **high-technology companies** and also to have some of the highest discounts, ostensibly reflecting greater risk. We are unpersuaded that these 13 companies are comparable to the partnership. **If these 13 companies are removed** from [TP Appraiser's] guideline group, the median discount of the remaining 26 companies is 19.45 percent

LAPPO V. COMMISSIONER

- ▶ [IRS Appraiser] relied primarily on the **Bajaj regression method**...we are unpersuaded that a 7.2-percent discount is an appropriate quantitative starting point

Special Note

- Court's reasoning is **contradictory**
 - Relied on Bajaj private placement study
 - Most of companies in that study are **high-technology**.

DL0M in U.S. Tax Court FLP Cases

FAILURE TO ANALYZE

- ▶ “To the extent [TP Appraiser #1] believes that the **benchmark range** of discounts we utilized in *Mandelbaum v. Commissioner* is controlling in this or any other case, **he is mistaken. Nothing in *Mandelbaum*** suggests that we ascertained that range of discounts for any purpose **other than the resolution of that case.** ”

PERACCHIO

- ▶ [TP Appraiser #2] cites a series of empirical studies known as **restricted stock studies**, which, according to him, “**center around a 30% marketability discount** for transfers of restricted stock.”
- ▶ While restricted stock studies certainly **have some probative value** in the context of marketability discount analysis, [TP Appraiser #2] **makes no attempt whatsoever to analyze** the data from those studies as they relate to the transferred interests.

DL0M in U.S. Tax Court FLP Cases

FAILURE TO ANALYZE

- ▶ “After considering...the results of **the restricted stock studies**, [TP Appraiser] determined...a 38-percent marketability discount. **[TP Appraiser] did not analyze the data** from these studies as they related to the transferred interests herein, and therefore **we cannot accept the premise that this average discount is appropriate.**”

KELLEY

- ▶ “[IRS Appraiser’s] conclusion based on the [Bajaj’s regression] study is **not entirely accurate.**”
- ▶ “As we find the parties’ assumptions and analyses concerning the marketability discount only minimally helpful, **we use our own analysis and judgment.**”

DISCOUNTS FOR FAMILY LIMITED PARTNERSHIPS

Mary Lou Edelstein, Appeals Officer, IRS

October 20, 2006

- ▶ In cases where the IRS cannot successfully argue to set aside the FLP for tax purposes, the focus shifts to determining the correct **valuation** of its assets
- ▶ The IRS generally considers **two basic issues**:
 1. **Validity** - §§ 2036 and 2038
 2. **Valuation**
- ▶ With the three decisions, *McCord*, *Lappo* and *Peracchio*... the Tax Court has become more **sophisticated in its analysis**...
- ▶ *Kelley*...this case is an anomaly...and should not be considered...

DL0M Results in Five Valuation Cases

	<u>Taxpayer</u>	<u>IRS</u>	<u>Tax Court</u>	<u>Average</u>
McCord	35.0%	7.2%	20.0%	20.7%
Lappo	35.0%	8.3%	24.0%	22.4%
Peracchio	40.0%	15.0%	25.0%	26.7%
Kelley	38.0%	14.1%	23.0%	25.0%
Holman	35.0%	12.5%	12.5%	20.0%

Tax Court FLP Cases

Summary of Asset Classes

Volatility and Discount

	<u>McCord</u>	<u>% Total</u>	<u>Volatility</u>	<u>Lappo</u>	<u>% Total</u>	<u>Volatility</u>	<u>Peracchio</u>	<u>% Total</u>	<u>Volatility</u>	<u>Kelley</u>	<u>% Total</u>	<u>Volatility</u>
Cash							\$834	42.5%	5.0%	\$1,226	100.0%	5.0%
Municipal Bonds	\$8,040	45.5%	10.0%				\$151	7.7%	10.0%			
Common Stock	\$3,642	20.6%	15.0%	\$1,319	41.5%	15.0%	\$976	49.8%	15.0%			
Real Estate-Distributing				\$1,860	58.5%	15.0%						
Real Estate Non-distributing	\$5,776	32.7%	30.0%									
Oil & Gas	\$215	1.2%	20.0%									
Total	\$17,673		17.7%	\$3,179		15.0%	\$1,961		10.4%	\$1,226		5.0%
DLOM	20.0%			23.0%			25.0%			23.0%		

DLOM in U.S. Tax Court FLP Cases

MULTIPLE DISCOUNTS

- ▶ Petitioners were allowed a 20% discount on the farmland's value due to "blockage" or absorption.
- ▶ TIERED DISCOUNT: The FLP owned a 50% GP interest in another land owning partnership ("Pine Bend"). The Tax Court decided on a 30% combined discount
- ▶ Minority Interest discounts of 16.27% and 17.47% applied for the two gift dates (1996 and 1997)
- ▶ DLOM - discounts of 21.23% and 22% applied for the two gift dates (1996 and 1997). No explanations given but Court adopted the IRS view-which was higher than taxpayer's.

ASTLEFORD V. COMMISSIONER

- ▶ It appears IRS DLOM higher than taxpayer's expert because IRS argued for:
 - Zero absorption discount
 - Zero discount for Pine Bend interest
 - "Unreasonably" low discounts for minority interest
- Had the IRS applied a tiered discount structure, presumably, the DLOM it finally arrived at would have been lower. Taxpayer's DLOM was but 15%, no doubt due to the tiered structure relating to the Pine Bend interest.

DL0M in U.S. Tax Court FLP Cases

ASSIGNEE INTEREST ARGUMENT LOSES (AGAIN)

- ▶ Petitioners argued that the 88.99% interest held by the decedent was an assignee interest and not a LP interest.
- ▶ Petitioner's expert determined a minority interest discount of 13,4% and a DL0M of 27.5% using restricted stock studies. Also stated that if the interest was deemed to be an LP interest, its opinion would have been "different" (i.e. much lower).
- ▶ IRS expert rejected a minority interest discount but allowed a DL0M of 18%.
- ▶ The Court held the interest was not an assignee interest.

STREIGHTOFF V. COMMISSIONER

- ▶ The case illustrates how hard it is for the taxpayers to win the assignee interest argument. Taxpayers have lost on this issue a number of times, including:
 - Jones v. Commissioner (2001)
 - Kerr v. Commissioner
 - Astleford v. Commissioner

JONES V. COMMISSIONER 116 T.C. 121 (T.C. 2001)

► Valuation of Interests in two FLPs owning ranch land

1. JBLP

- i. Founder transferred a 83.08 % interest to son
- ii. Gift immediately after formation
- iii. Transferred interest controlled the partnership
- iv. Discount allowed – 8% for DL0M, no DL0C discount

2. AVLPL

- i. Founder transferred 16.915% interests to each of four daughters
- ii. Discounts allowed – 40% combined DL0C/DL0M plus additional 8% DL0M

JONES V. COMMISSIONER 116 T.C. 121 (T.C. 2001)

► IRS argued gifts were of property-not LP interests

- The Court disagreed: Decedent contributed property to the partnerships and received continuing limited partnership interests in return. All of the contributions of property were properly reflected in the capital accounts of decedent, and the value of the other partners' interests was not enhanced by the contributions of decedent. Therefore, the contributions do not reflect taxable gifts.

JONES V. COMMISSIONER 116 T.C. 121 (T.C. 2001)

- ▶ *IRS argued Section 2704(b) negates partnership restrictions*
 - The Court disagreed: Respondent's argument is essentially the same as the argument we rejected in *Kerr v. Commissioner*, 113 T.C. 449, 469-474 (1999)....the Court concluded that the partnership agreements in *Kerr* were not more restrictive than the limitations that generally would apply to the partnerships under Texas law.

DLOM in U.S. Tax Court FLP Cases

JONES V. COMMISSIONER 116 T.C. 121 (T.C. 2001)

JBLP Valuation Discounts on 83.1% interest

	Taxpayer's Appraiser	IRS' Appraiser	Tax Court
"Secondary Market" discount	55%	0%	0%
Additional DLOM	20%	0%	8%
Built in Gains Deduction	\$(undisclosed)	0%	0%

AVLP Valuation Discounts on 16.9% interest

	Taxpayer's Appraiser	IRS' Appraiser	Tax Court
"Secondary Market" discount	45%	38%	40%
Additional DLOM	20%	8%	8%
Built in Gains Deduction	\$(undisclosed)	0%	0%

JONES V. COMMISSIONER 116 T.C. 121 (T.C. 2001)

- ▶ TP Appraiser was instructed to value interest as (non-voting) assignee interest
 - The Court disagreed:
 1. First, the documents entitled "Gift Assignment of Limited Partnership Interest", created by decedent to carry out the transfers, state that, after the transfers are complete, each child will hold his or her newly acquired interest as a "limited partnership interest".
 2. Second, in his 1995 Federal gift tax return, decedent describes the gifts as "limited partnership interests" rather than assignee interests.
 3. Third, in an affidavit... A.C. Jones states that the gifts that he and his sisters received from decedent were "limited partnership interests".
 4. Fourth, the ...Federal income tax returns... designate the interests as LP interests.

JONES V. COMMISSIONER 116 T.C. 121 (T.C. 2001)

► TP Appraiser reduced the value for Built-in Gains Taxes

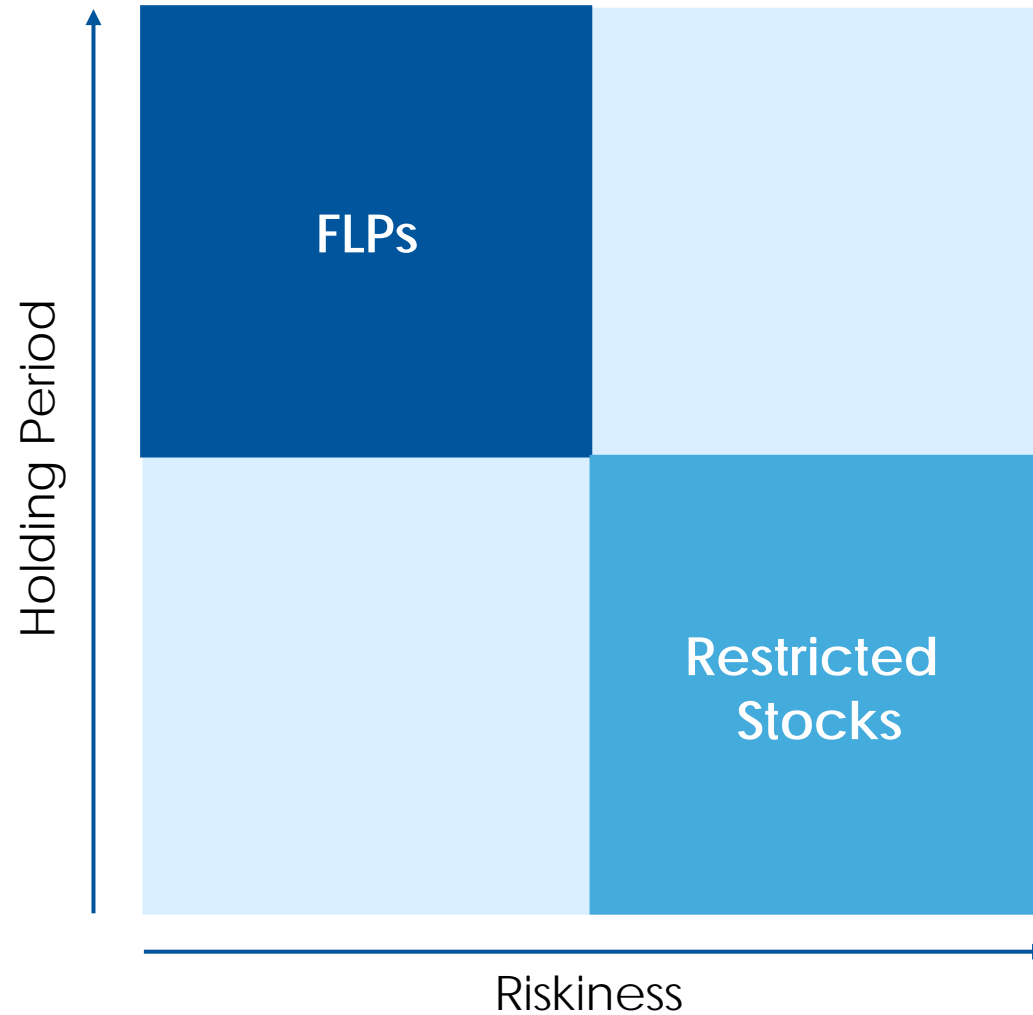
- The TP Appraiser opined that use of the 754 election was uncertain and that some reduction in value was necessary. The Court disagreed:
 - His opinion that the election was not certain...was based solely on the position of A.C. Jones, asserted in his trial testimony, that, as general partner, he might refuse to cooperate with an unrelated buyer of the 83.08-percent limited partnership interest...We view A.C. Jones' testimony as an attempt to bootstrap the facts to justify a discount that is not reasonable under the circumstances.

HOLMAN V. COMMISSIONER

- ▶ [TP Appraiser] concludes that (1) the willing buyer of a limited partner interest “has **no real prospects of being able to sell** the interest in the public market at the full, freely traded value at any time,” and (2) “there is virtually **no ready market** for * * *[interests in the partnership]”
- ▶ [TP Appraiser] believe[s] that the discount for lack of marketability should be at least 35%
- ▶ If [TP ‘s Appraiser] assumptions ...are accepted, “then the conclusion is unavoidable that the value of limited partnership interests...is virtually zero, or that **they cannot be valued at all.**”
- ▶ [TP’s Appraiser] has not persuaded us that his stopping point, 35 percent, is anything but a **guess**
- ▶ “We need not rely on the unsupported opinion of an expert witness’”

DLOM In U.S. Tax Court FLP Cases

Comparison of Characteristics



Bailey v. Commissioner

Confusion about the holding period

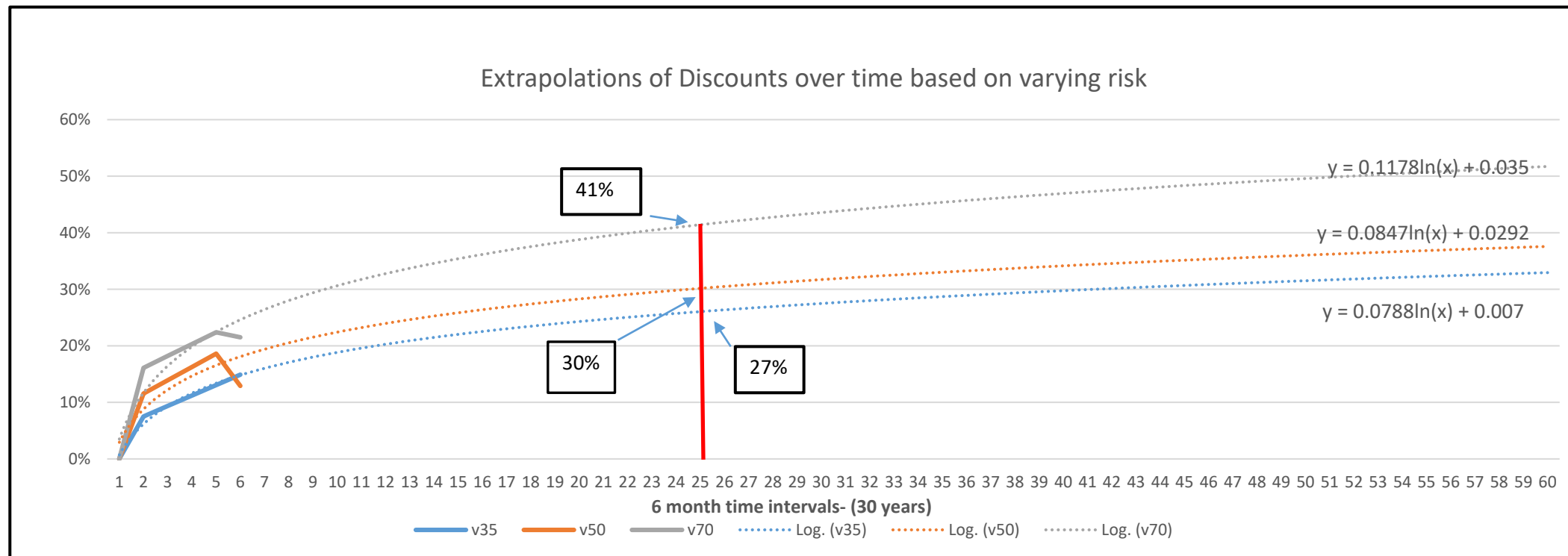
"The **restricted stock studies** that [petitioner's expert] relied upon analyzed stocks that had a **holding period of 2 years or less**. The record contains no evidence, however, to support an assumption that an investor in C&L Bailey would likely have such a short-term investment horizon.

To the contrary, the evidence in the record strongly suggests that since the inception of C&L Bailey, there has been no trading of its shares, suggesting that **the hypothetical willing buyer who is representative of prospective investors in C&L Bailey might well have a longer investment horizon than the investors of the restricted stocks analyzed in the studies.**"

DLOM In U.S. Tax Court FLP Cases

<u>DLOM - Volatility and Holding Period</u>				
<u>Stout Study - 6 Month Holding Period</u>				
Quartile	I	II	III	IV
Average Volatility	18.4%	42.3%	58.4%	68.9%
Average Discount	6.3%	8.7%	14.4%	16.1%
<u>Bajaj Study - Post 1990 - 2 Year Holding Period</u>				
Quartile	I	II	III	IV
Average Volatility	50.5%	69.8%	84.1%	131.8%
Average Discount	18.6%	22.4%	32.7%	40.2%
<u>FMV Pre-1990 Study - 2.5 Year Holding Period</u>				
Quartile	I	II	III	IV
Average Volatility	37.6%	57.0%	73.3%	127.2%
Average Discount	14.9%	12.9%	21.5%	34.0%

DLOM In U.S. Tax Court FLP Cases



The Rise of the Income Approach in FLP Valuation

ELKINS V. COMMISSIONER

Estate of Elkins v. Comm'r, 140 T.C. No. 5 (U.S.T.C. Mar. 11, 2013)

Estate of Elkins v. Comm'r, 767 F.3d 443 (5th Cir. 2014)

- ▶ Fifth Circuit, reversed the prior Tax Court opinion
- ▶ The Fifth Circuit opinion reinstated the marketability discounts
- ▶ Undivided interests in art
- ▶ The taxpayer's expert relied on evidence from art experts
 - The value of the art on an undivided basis,
 - The holding period for the art,
 - Rates of return data from various art research studies, and anticipated inflation

The Rise of the Income Approach in FLP Valuation

ELKINS V. COMMISSIONER

- ▶ The expert was able to determine the rate of return a hypothetical buyer of an undivided interest in art would expect
- ▶ Assumed 10-year holding period was a reasonable basis on which to assess discounts.
- ▶ This analysis was applied to 64 works of art
- ▶ The range of the discounts determined was from 51.7%-79.7%
- ▶ The IRS maintained that no discounts were appropriate
- ▶ The IRS did not produce any expert testimony
- ▶ The Tax Court opined that some amount of the taxpayer's discounting was appropriate but found it to be too high
- ▶ Using its own logic, the Court determined a 10% discount

The Rise of the Income Approach in FLP Valuation

ELKINS V. COMMISSIONER

- ▶ The Fifth Circuit ruled that the IRS did not meet its burden of proof since it did not produce any valuation evidence
- ▶ However, it also noted that the Tax Court had **no basis for its 10% discount**
- ▶ The **only valuation opinion left** to be considered was that of the taxpayer
- ▶ **Not just a win by default** for the taxpayer's expert
- ▶ The Fifth Circuit further stated: "...**We conclude that the discounts determined by the Estate's experts are not just the only ones proved in court; they are eminently correct.**"

The Rise of the Income Approach in FLP Valuation



GRIEVE V. COMMISSIONER

Only US Tax Court case involving an FLP accepting, as filed, the TP's appraiser's value

But, note:

1. IRS appraiser's novel and speculative valuation theory was rejected leaving the taxpayer's valuation arguments **unopposed**
2. There have been several **Federal circuit court** cases wherein the taxpayer's appraiser's work has been accepted as filed: e.g., **Church, Murphy, Keller** (*Church* and *Keller* had no opposing IRS valuation arguments)
3. IRS expert reports have been accepted as filed in **Holman** and **Streightoff**
4. Taxpayers' appraisals have been restored as the final value upon appeal in **McCord** and **Elkins**

The Rise of the Income Approach in FLP Valuation



GRIEVE V. COMMISSIONER

- ▶ Dealt with the valuation of a large majority interest (99.8%) with no voting rights in a holding entity
- ▶ There were two separate entities involved but the valuation facts were nearly identical
- ▶ Both held primarily public stock and cash
- ▶ The taxpayer's initial expert, whose valuation was used for filing purposes (but not at trial), used a relatively standard restricted stock study analysis to determine the lack-of-marketability discount, concluding on discounts of 25% for both entities

The Rise of the Income Approach in FLP Valuation

GRIEVE V. COMMISSIONER

- ▶ *First use of the NICE method in Tax Court*
- ▶ *The Court did not adopt it but it was not critical of it*



The NICE Method – the Income Approach to Valuing FLPs

GRIEVE V. COMMISSIONER – THE “SILENT” ENDORSEMENT

- ▶ The Court:
 - “...we conclude that the market approach is a reasonable method.”
 - The court did not say the market approach was the only or even the most reasonable approach but that it was merely a reasonable approach
- ▶ The only alternative discussed in this case was the NICE Method



The NICE Method – the Income Approach to Valuing FLPs

GRIEVE V. COMMISSIONER – SUPPORT FROM THE IRS EXPERT

The Court: "...do you have any concerns about the NICE method in general?"

IRS Valuation Expert: "Oh, I could probably make some academic arguments that would interest nobody in the room but me and Mr. Frazier. But in a general sense, I think it gets it at the correct points. "

The Court: "So you think it's a reasonable approach overall?"

IRS Valuation Expert: "Overall –"

The Court: "Okay."




Nelson v. Commissioner

- ▶ The **taxpayer's expert** looked to several studies on the sales of restricted stock with a two-year holding period and private, pre-initial-public-offering (IPO) stock
- ▶ The **IRS' valuation expert** compiled a range of discounts by using:
 - Quantitative models that looked at the role of liquidity premiums in calculating the value of a forgone put option on the basis of the Black-Scholes model and considering hypothetical rates of return
 - He also examined several studies on the sales of restricted stock and pre-IPO stock, but these studies involved more recent data

Nelson v. Commissioner (cont.)

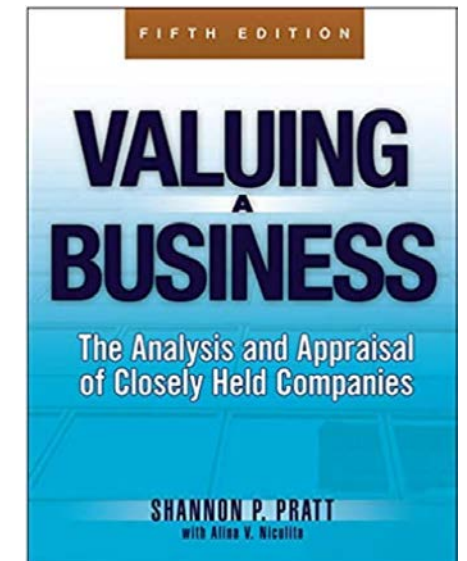
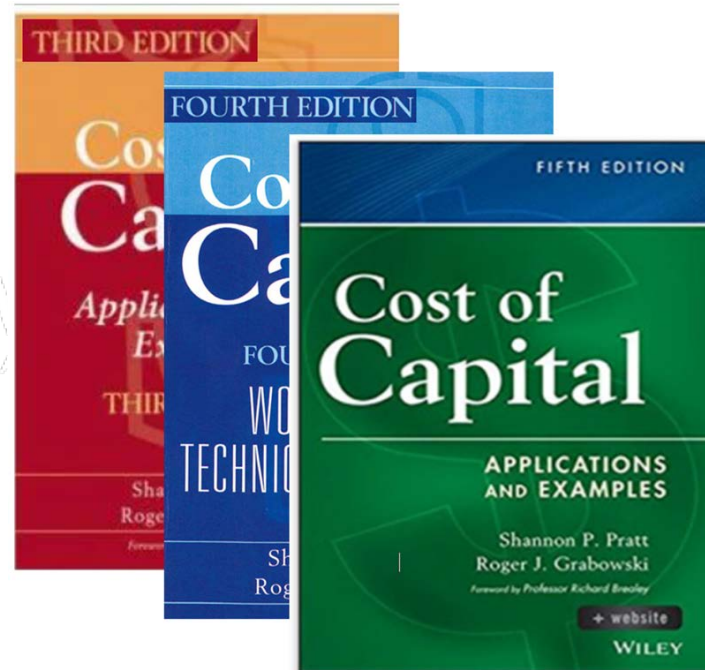
" [Taxpayer's expert's] analysis depends on several studies on the sale of restricted stock and private, pre-IPO stock that have been brought to the attention of this Court before... And in those cases **we have repeatedly disregarded experts' conclusions** as to discounts for long-term stock holdings when based on these studies. See *Estate of Bailey v. Commissioner*, 2002 WL 1315805, at *10; *Furman v. Commissioner*...Accordingly, we will disregard [Taxpayer's expert's] conclusions as to a discount... which was based on these studies."

A photograph of two women in an office environment. The woman on the left has blonde hair and is wearing a light-colored top. The woman on the right has dark hair, wears glasses, and is also wearing a light-colored top. They are both smiling and looking towards a laptop screen. A large, semi-transparent white arrow graphic points from the left towards the right, passing over the women. The background is slightly blurred, showing office furniture and windows.

The NICE Method: the Income Approach to Valuing FLPS

The NICE Method

- ▶ The **NICE Method** is featured in the leading textbook on the cost of capital
- ▶ The **NICE Method** will be included in the forthcoming sixth edition of Valuing a Business – the leading valuation textbook



Traditional Approach v. NICE Method

XYZ Family Limited Partnership			
<u>Traditional Method</u>		<u>NICE Method</u>	
Net Asset Value	\$10,000,000	Expected Total Return from Partnership	9.00%
Discount-Minority Interest @ 10%	(\$1,000,000)	Additional Return for Minority Interest	1.50%
Discount-Lack of Marketability @ 30%	(\$2,700,000)	Additional Return for Lack of Marketability	3.75%
		Total required Return	14.25%
Fair Market Value	\$6,300,000	Fair Market Value	\$6,315,789

$$(\text{Present}) \text{ Value} = \frac{D}{(1+r)^n}$$

- ▶ **D** =the **expected future distributions**
- ▶ **r** =the annual cost or rent of money described as the required ROR or “discount rate” - **RISK**
- ▶ **n** =the number of years from the present to the expected future realization of funds through the sale of the asset **HOLDING PERIOD**

Valuation Discounts in Disputes

Valuation and Estimated Tax Effects of Transfers of Minority Interests in FLPs				
		Scenarios		
		IRS View	Taxpayer's View	
NAV	\$10,000,000	\$10,000,000	\$10,000,000	
Total Interest Being Valued*	80.0%	80.0%	80.0%	
Pro-rata NAV	\$8,000,000	\$8,000,000	\$8,000,000	
Discount for Lack of Control	10.0%	10.0%	10.0%	
Discount for Lack of Marketability**	25.0%	25.0%	35.0%	
Combined Discount	32.5%	32.5%	41.5%	Differential 9.0%
FMV of LP Interest	\$5,400,000	\$5,400,000	\$4,680,000	
Tax Rate	40.0%	40.0%	40.0%	
Tentative Tax	\$2,160,000	\$2,160,000	\$1,872,000	
Available Credit	\$10,000,000	\$10,000,000	\$10,000,000	
Taxes Due	\$0	\$0	\$0	\$0
<i>*May be multiple gifts of minority interests</i> <i>** for discussion purposes only considering DLOM differential</i>				

Meet the Speakers



William H. Frazier, ASA

Managing Director,
Valuation Services

William H. Frazier, ASA, has over 40 years of experience in valuation, investment banking, mergers and acquisitions, and litigation advisory services. For the last 15 years, Will's career focus has included valuing family-owned businesses and holding entities, such as family limited partnerships. He has performed valuations for estate and gift taxation, fairness/solvency opinions, bankruptcy and reorganization, disputes related to business transactions and shareholder disputes, family law matters, purchase and sale advisement, employee stock ownership plans, equity compensation, financial reporting, and other litigation, tax and corporate matters. Additionally, Will has served as an expert witness and appraiser in several U.S. Tax Court cases.

Meet the Speakers



Sonia Desai, CPA

Partner, Forensics and
Litigation Services

Sonia Desai, CPA, ABV, ASA, CBV, is a partner in the Forensics and Litigation Services and Valuation Services practices at Weaver; she leads the Valuation Services practice in our Austin office. Sonia has over 16 years of experience in valuation, litigation, investigations and audit, including serving as an expert witness. She combines her experience in valuation and litigation to provide expert witness services involving valuation of closely held businesses and equity ownership, such as in shareholder and partner disputes, family law and commercial disputes. Her work in family law includes tracing and characterization, as well as quantification of financial claims. Sonia also has significant experience in advising clients on the value of assets and business interests for estate and gift tax planning, mergers & acquisitions and financial reporting.



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