Practical Issues When Appraising Privately Held Business

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PRACTICAL ISSUES WHEN APPRAISING PRIVATELY HELD BUSINESSES

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PRACTICAL ISSUES WHEN APPRAISING PRIVATELY HELD BUSINESSES

I. Factors to Consider Before Engagement of a Valuation Expert

A. Use of Experts to Establish a Taxpayer’s Position of Value

1. The complexity of the facts relevant to the resolution of the controlling issues in a tax controversy frequently requires counsel’s employment of one or more experts in various factual areas to assist in counsel’s assimilation of the facts within the taxpayer’s theory of the case, evaluate critically the Internal Revenue Service’s case-in-chief and to provide expert testimony at trial. Factual areas for which an expert’s assistance may be beneficial to counsel include:

   a. Property appraisals.
   b. Industry practices and conditions.
   c. Arm’s-length nature of intercompany price, royalty or service fee.
   d. Appropriateness or logic of an accounting method.
   e. Relative significance of intangibles in generating a party’s income.
   f. Labor productivity.
   g. Financial and cost accounting.
   h. Patent, securities or other domestic legal areas.
   i. Foreign law.

2. Experts, who are retained in connection with a potential tax controversy (regardless of the stage of the controversy), always should be retained formally by legal counsel (i.e., the taxpayer’s General Counsel or preferably by outside tax litigation counsel) to ensure maximum protection for the expert’s work product and correspondence under the attorney-client privilege and work product doctrine during audit and pretrial discovery.

3. Before any employment relationship is formalized, the attorney should undertake to perform a comprehensive conflict check to make sure there are no
conflicts of interest between the expert and his or her firm and the taxpayer. Not only is the failure to determine a conflict embarrassing and costly, it can result in the ultimate disqualification of the expert. For example, in *International Business Machines v. United States*, 2000 TNT 146-17 (Fed. Cl. 7/18/00), an expert from a French law firm was disqualified from testifying on behalf of IBM because the Justice Department was using an expert from the same law firm in the same litigation. The French law firm, an affiliate of Ernst & Young LLP, had failed to identify both the pre-existing relationship of IBM with Ernst & Young LLP, the accounting firm, and the law firm’s representation of both sides in the dispute. The court found the creation of a so-called “Chinese Wall” an inadequate solution to the conflicts problem.

4. The expert’s employment relationship should be documented by a formal retention letter executed by counsel and the expert. Careful consideration should be given to whether the expert’s engagement will be conducted under either or both the attorney-client privilege or the attorney work product doctrine. Although an engagement with attorney-client privilege may yield better protection, broad waiver rules apply if the expert later becomes a “testifying expert.” Even in the case of work product, use of an expert in a testifying role will subject the expert’s related files (including conversations with counsel) to disclosure.

5. Care should be exercised in disclosing facts to, and exchanging correspondence with, the expert. Experts, their work product, and communications with counsel and the client, can be subject to extensive pretrial discovery both during the audit and in the Tax Court. As a general rule, all materials or communications disclosed to an expert should be assumed to be subject to IRS discovery.

6. Before retaining an expert, the taxpayer and tax counsel should determine the precise scope of the expert’s assignment and the intended use of the expert (e.g., testifying, nontestifying expert). This determination directly influences the selection of a particular expert, the specific facts and documents provided to the expert and the effective utilization of the expert in the case. If it is intended that the expert will testify at a trial, precautions should be undertaken to ensure that the expert’s evidence will be relevant and reliable as outlined by the Supreme Court in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993) and *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 119 S.Ct. 1167 (1999). For a fuller discussion of the *Kumho Tire* opinion, see Littleton, *Kumho Tire-Supreme Court Dramatically Changes the Rules on Experts*, and Cavanagh, *Kumho Tire-Decision Extends Daubert Approach to All Expert Testimony*, New York State Bar Journal, Vol. 71, No. 6 (July/August 1999).

7. An expert also can be used to provide opinion to an examination agent or an Appeals Office during the IRS’s administrative proceedings. There are several important caveats to such use of the expert: since the expert’s opinion has been disclosed, the IRS may immediately request the expert’s written report, work papers and correspondence on the ground that any privileges have been waived by offering the expert’s opinion to the IRS. Materials or assertions revealed by the expert might be
used to impeach his opinion offered at trial or as admissions against the taxpayer. Thus, the expert’s opinion should never be offered at the Examination or Appeals level unless counsel is relatively certain that the client’s trial position will remain substantially unchanged.

8. The IRS may attempt to use the taxpayer’s expert opinion in its own case-in-chief if the taxpayer fails to offer the expert’s opinion at trial. The IRS increasingly is involving its trial counsel during the administrative proceedings of large cases. The IRS will generally wish to interview or depose any expert used during the audit or at the Appeals level. Thus, the taxpayer’s expert opinion revealed at these administrative levels may receive a substantial level of critical scrutiny even prior to the case being docketed in court.

9. An expert also can be deployed productively in a nontestifying role as an advisor to counsel. If highly technical expert evidence is required for litigation, counsel might not be competent to prepare the testifying expert without the assistance of the testifying expert himself or another expert. If counsel relies exclusively on the testifying expert for such preparation, there is a substantial risk that information disclosed to him will become discoverable by the opponent. One way to avoid such a trap is to use a nontestifying expert as an adviser to counsel in planning and developing the testifying expert a testimony.

10. A nontestifying expert also can provide invaluable assistance in the following areas:

   a. helping to anticipate the IRS’s position and developing defenses to those positions;

   b. assisting in discovery;

   c. assisting in the interrogation of opposing experts;

   d. assisting in stipulations; and

   e. marshaling facts and technical resources in the expert’s areas of expertise.

B. The Business Valuation Professional Environment

1. The Appraisal Foundation and Uniform Standards of Professional Appraisal Practice

b. The Appraisal Foundation has two boards, Appraiser Qualifications Board ("AQB") and the Appraisal Standards Board ("ASB").

(i) The purpose of the AQB is to develop and promote meaningful criteria by which appraiser competence can be measured.

(ii) The purpose of the ASB is to set standards of appraisal.

2. Guidance of USPAP

a. USPAP is promulgated annually.

b. The ASB promulgates the "Standards". The ASB also promulgates Statements on Appraisal Standards that clarify, interpret, explain or elaborate on the Standards, and have the same weight as Standards. The ASB also issues Advisory Opinions to offer guidance to appraisers, but which do not have the weight of the Standards or Statements on Appraisal Standards.

c. USPAP also contains a Definitions Section, a Glossary, a Preamble and five rules pertaining to ethics, competency, departure, jurisdictional exception and supplemental standards.

d. There are no licensure requirements in most states for business appraisers and, accordingly, no requirement that USPAP be followed. The IRS does not require that appraisers follow USPAP. However, certain appraisal organizations, such as the American Society of Appraisers, do require their members to follow USPAP in business valuation appraisal assignments.

e. In 1989, FIRREA required that real estate appraisals used in conjunction with federally related transactions be performed in accordance with USPAP.
3. USPAP's Ten Standards


b. Standard 9 pertains to the development of a business or intangible asset appraisal. Standards Rule 9-4 requires appraisers to use all valuation approaches that apply to the engagement and to examine a list of valuation factors that are similar, but not identical, to the "eight factors" set forth in Rev. Rul. 59-60.

c. Standard 10 covers the reporting of a business or intangible asset appraisal. Two reporting options are available; Appraisal Report or Restricted Use Appraisal Report. The intended use of the appraisal when a Restricted Use Appraisal Report is issued must be for client use only. Standard 10 contains four Standards Rules.

C. The International Valuation Standards Committee (IVSC)

a. The objective of the IVSC is to formulate and publish, in the public interest, valuation Standards and procedural guidance for the valuation of assets for use in financial statements, and to promote their worldwide acceptance and observance. The second objective is to harmonize Standards among the world's states, and to make disclosures of differences in standards statements and/or applications of Standards as they occur. It is a particular goal of IVSC that international valuation Standards be recognized in statements of international accounting and other reporting standards, and that Valuers recognize what is needed from them under the standards of other professional disciplines.
For International Valuation Guidance Note No. 6 pertaining to business valuations - See Appendix A. Guidance Note 6 Business Valuation is published within the 6th edition of International Valuation Standards (2003). The Guidance Note has been reproduced with the permission of the International Valuation Standards Committee (IVSC) who hold the copyright. The IVSC cautions that the individual Standards, Applications and Guidance Notes are a component part of the entirety of 6th edition of the International Valuation Standards (2003). The reading of the entire document is advised for the understanding and use of the International Valuation Standards. The approved text of the 6th edition of International Valuation Standards (2003) is that published by the IVSC in the English language. For information on obtaining a copy, please visit the IVSC website, http://www.ivsc.org; email the IVSC on ivsc@ivsc.org; or fax +44 1442 879306.

D. Professional Business Appraisal Organizations

1. American Society of Appraisers

The ASA is a multi-appraiser discipline association that provides accreditation in several appraisal subspecialties (business valuation, gems and jewelry, machinery and technical specialties, personal property, real property and appraisal review) at two different experience levels: Associate Member (“AM”) and Accredited Senior Appraiser (“ASA”). The AM credential requires a college degree, two years of appraisal experience, complete four courses and a qualifying exam, together with peer review of an appraisal report prepared by the AM candidate. The ASA credential requires the candidate to become AM credentialed and obtain an additional three years of appraisal experience.

2. Institute of Business Appraisers

The Institute of Business Appraisers offers four primary designations: Certified Business Appraiser (“CBA”), Master Certified Business Appraiser (“MCBA”), Fellow of the Institute of Business Appraisers (“FIBA”), and Business Valuation Accredited for Litigation (“BVAL”). The CBA requires a four-year college degree, completion of IBA coursework or five years of full-time active experience as a business appraiser, successful completion of an examination, and successful review of two business appraisal reports.
3. National Association of Certified Valuation Analysts

The NACVA offers three designations: Certified Valuation Analyst ("CVA"), Accredited Valuation Analyst ("AVA"), and Certified Forensic Financial Analyst ("CFFA"). The CVA requires a valid and unrevoked CPA license, completion of a five day training program and successful completion of an examination. The AVA does not require a CPA license but does require at least two years of business valuation experience, completion of ten or more business valuation engagements in which the candidate’s involvement is referenced in the report, completion of a five day course, and successful completion of an examination.

4. American Institute of Certified Public Accountants

The AICPA offers the Accredited in Business Valuation ("ABV") designation only to members of the AICPA who hold CPA licenses. The ABV requires the passage of an exam and performance of significant services in at least ten valuations.

5. Association for Investment Management and Research

The AIMR is not an appraisal association; instead it is an organization of investment practitioners and educators. The AIMR offers the Chartered Financial Analyst designation ("CFA"). CFA holders must pass a three-part examination over a three-year period, which is widely recognized to be far more rigorous than any of the exams of the various appraisal associations, and adhere to the AIMR standards and regulations. The CFA curriculum and exam covers the analysis of equity and fixed income securities, derivatives, portfolio management, quantitative methods, ethics and professional standards, accounting and financial statement analysis, corporate finance and economics.

II. Selecting a Valuation Expert

A. Locating the Expert

1. Do you need a nationally recognized expert or a local, well qualified, expert?

2. A national expert may be more appropriate if the case involves a large amount in dispute, issues are complex, numerous experts (different specialties) may be needed, etc. Sometimes the level of specialty cannot be found among local experts, i.e., industry, knowledge.

3. Locating the appropriate expert may come from a variety of sources. For example, leads from litigators, by line of expertise, from similar cases,
review of Tax Court valuation cases, universities, trade associations and industry leads, etc.

B. **Selection Criteria for Experts**

1. Appropriate qualifications;
2. Type of expert;
3. Use of De Facto experts;
4. Familiarity with recent developments;
5. Communications ability;
6. Objectivity;
7. Experts with baggage.

C. **Retaining the Expert**

1. Always use a written engagement agreement with the expert witness that contains the essential terms of employment, together with appropriate confidentiality and control provisions.

2. Keep in mind the following points:
   a. Never agree to pay an expert witness contingent fees.
   b. The attorney, not the client, should directly execute the expert witness engagement agreement as the retaining party, so that the attorney-client privilege and the attorney work product privilege can be preserved.
   c. The agreement should provide that all information, data, records, etc., provided to the expert or gathered by the expert will remain confidential and may not be disclosed to third parties other than the attorney in the absence of the attorney’s instructions.
   d. The agreement should specify that all information and work product of the expert will remain the exclusive property of the retaining attorney, and all will be surrendered upon request of the attorney and/or
delivered to the attorney at the conclusion of the engagement.

e. The agreement should specify that the attorney will be advised immediately in the event the expert receives any summons, subpoena, or other legal process compelling production of any information or work product.

f. The agreement should provide that the expert is engaged solely to provide truthful testimony regarding the issues, and should provide that the expert is to act independently of counsel.

g. The agreement should contain various representations from the expert to the effect that no legal or ethical conflicts of interest exist that would impair the expert's independence and objectivity under the engagement.

III. Accountant’s and Attorney’s Role in Assisting the Appraiser

A. General Data

1. To assist an appraiser in completing an appraisal, or if the practitioner is attempting to prepare an informal appraisal of a business (whether a closely held corporation, partnership, or sole proprietorship), of interest are the following types of information:

a. audited financial statements and copies of the federal and state income tax returns for the previous 3 to 5 years;

b. a list of subsidiaries or affiliated companies;

c. the fixed asset list and depreciation schedule;

d. copies of all contracts, including leases and stock purchase or other types of purchase agreements;

e. compensation schedule of principals;

f. schedule of insurance in force including life insurance;

g. budgets or projections;
h. marketing literature;

i. information concerning tangible assets such as patents or trademarks;

j. any other appraisals or consulting reports relating to the assets of the business.

k. information relating to commitments to pension, profit sharing, stock option or other qualified plans;

l. copies of business and personal loan applications made in the preceding several years; and

m. information concerning contingent or off balance sheet assets or liabilities, such as pending lawsuits or warranty claims.

2. The exact nature and the amount of general data necessary in any appraisal are matters of judgment.

IV. The Basics

A. Getting the Court to Believe in Your Expert Witness' Opinion as to Value

1. If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise. Fed. R. Evid. 702; Daubert v Merrell Dow Pharmaceuticals, 509 U.S. 579 (1993).

2. The court is not bound by the opinion of any expert nor must it accept an expert's testimony. Trial judges have substantial discretion and considerable leeway to determine how to evaluate relevance and reliability and to make a determination whether to admit the expert evidence.

3. Expert evidence is weighed in light of the demonstrated qualifications of the experts and all other relevant evidence. All types of expert evidence are subject to the relevance and reliability "gatekeeping function" that the Supreme Court articulated in Daubert with respect to scientific evidence. Kumho Tire, supra. See Estate of Gilford v. Commissioner, 88 T.C. 38 (1987). The court can adopt
certain portions of an expert's testimony and reject other portions of the testimony. 
*Lukens v. Commissioner*, 945 F.2d 92 (5th Cir. 1991).

4. However, the court may not substitute its best judgment for that of the experts without spelling out its reasoning for doing so, *i.e.*, it may not "leap to a figure intermediate between petitioner's and the Commissioners." *Leonard Pipeline Contractors, Inc. v. Commissioner*, 142 F.3d 1133 (9th Cir. 1998).


6. The facts or data in a particular case upon which an expert bases an opinion or inference may be those perceived by or made known to him at or before the hearing. If the facts or data are of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, they need not be admissible into evidence. Fed. R. Evid. 703. Since Federal Rules of Evidence 703 permits an expert to base testimony on facts made known to the expert before trial and which might not be admissible into evidence, Federal Rules of Evidence 703 is, in essence, an exception to the hearsay rule. Thus, inadmissible hearsay can be incorporated into the record through an expert.

7. Generally, testimony in the form of an opinion or inference otherwise admissible is not objectionable because it embraces an ultimate issue to be decided by the trier of fact. Fed. R. Evid. 704. An expert may testify in terms of an opinion or inference and give reasons therefor without prior disclosure of the underlying facts or data, unless the court requires otherwise. The expert may be required, however, to disclose the underlying facts or data on cross-examination at trial. Fed. R. Evid. 705. In most cases, however, it is advantageous to present the facts or data to the Court to further the credibility of the expert's conclusions based thereon.

B. **Involvement of the Internal Revenue Service in Valuation Disputes**

1. Incurring the expense of obtaining an appraisal in order to comply with the regulations only to have the IRS redetermine the value is a frustrating experience. This problem may be avoided if the appraiser completely sets forth all factors affecting value and clearly expresses valid reasons for the relative weight given each factor in reaching a conclusion, although the IRS may differ with the taxpayer's appraiser based only upon the informal opinions of its experts. At this point, it is
important to insist that the IRS also secure a formal appraisal, which should considerably shorten settlement negotiations.

2. It is not unusual for the IRS' experts to enter a case shortly before the date of trial, which can be as much as five or six years after the valuation date. Generally speaking, when this occurs, the IRS' experts may be completely unfamiliar with the property until they are asked in to appraise it. Even after they familiarize themselves with all of the relevant factors, they are frequently at a disadvantage where there have been substantial physical changes in the property, the market, or in the geographical area in which it is located. For example, in *Mast v. Commissioner*, T.C. Memo 1989-438 (1989), the Tax Court disregarded the IRS expert's appraisal of photographic equipment donated to charity. The expert was retained shortly before trial and did not initially examine the property. The court also awarded the taxpayer litigation costs under I.R.C. § 7430, since the IRS originally had valued the property at zero (despite an appraisal in excess of $1 million by another expert the IRS hired but did not call at trial), had ample time to retain an expert before trial, and refused to compromise on the valuation. See also *Clemens v. Commissioner*, T.C. Memo 1992-436 (1992) (court evaluated the appraisals of two experts and made its own determination of value by adjusting petitioner's appraisal).

3. The taxpayer's experts should normally be local appraisers, thoroughly familiar with the property, so that they will be in a position to state the nature of the changes and to attach a value to them. The important point to be remembered is that the local experts can, by pointing out factors not specifically mentioned by the IRS' experts, cast doubts upon the IRS' experts' testimony or even upon their qualifications.

4. When consulting with experts for purposes of preparing the taxpayer's appraisal, it is important to document not only the expert's opinions, but the present status of the property, the area in which it is located, the present zoning, and the possibility of changes in zoning. This information will, of course, be useful to a professional appraiser after he or she is brought into the case.

5. For example, in *Sherman v. U.S.*, 79-1 USTC ¶13,288 (E.D. Va. 1979), the court accepted the valuation of the taxpayer's experts, who had a more intimate knowledge of the conditions in the market in the year of the decedent's death than did the government's expert, who appraised the real estate six years after the decedent's death. The taxpayer's experts were aware of a depressant factor on the real estate market resulting from a sewer moratorium imposed by the county at the time of the decedent's death, the limited frontage of the property requiring the construction of service roads before any development could take place, and the unknown factor of whether the property was really suitable for development in conjunction with the adjacent property. Similarly, in *Brown Est. v. Commissioner*, T.C. Memo 1962-249 (1962), the court accepted the testimony of the taxpayer's expert where the government's expert had not seen the property until several years after the valuation.
date, and was imprecise as to the effect to be given to the value of the substantial
improvements which had been made since the valuation date.

6. A distinction should be observed between a decision of a court to
accept or not accept the appraisal, e.g., the court reaches its own decision based upon
an analysis of the appraisals submitted by the parties, and the court's decision to accept
or not accept the person as a qualified expert.

7. Federal Rule of Evidence 702 relates to expert witnesses and their
use in civil litigation in the federal courts. Rule 702 is made applicable in Tax Court
litigation by Tax Court Rule 143. In McCampbell Est. v. Commissioner, T.C. Memo
1991-141 (1991), the Tax Court held that employees of the bank serving as executor
did not qualify, under the Federal Rules of Evidence, as experts for presenting opinions
on the valuation of real estate, and that they did not have any special knowledge that
would justify their testimony as lay witness opinion testimony.

held that the IRS' witness did not qualify as an expert witness because he did not have
actual personal knowledge of the facts affecting the land at the valuation date. In the
interval between the valuation date and the date on which the IRS' expert examined the
property, there were substantial and extensive changes to the property, thus making it
impossible for him to evaluate the property as of the proper date. And in Dougherty Est.
v. Commissioner, T.C. Memo 1990-274 (1990), the Tax Court gave little weight to one
of the taxpayer's appraisers because he was the executor and the decedent's son. The
opinion of another appraiser was also discounted because he lacked experience in the
geographic area the realty was located in and had extensive business dealings with the
decedent.

9. A professional appraiser may be assessed a penalty under I.R.C. §
6701(a) (up to $1,000 per document) for aiding or assisting in the preparation or
presentation of an appraisal where there is an understatement of tax liability. The
penalty is applicable to a person who knows or has reason to believe that the facts
relating to an understatement of tax liability are false.

10. In Rev. Proc. 66-49, 1966-2 C.B. 1257, the IRS outlined the types
of information which are to be contained in a competent appraisal of all types of
noncash property for which an appraisal is required, e.g., real property, tangible or
intangible personal property, and securities. The procedure is also appropriate for
unique properties such as art objects, literary manuscripts, and antiques (among
others), with respect to which the determination of value is often more difficult. Although
this Revenue Procedure is applicable principally for income tax purposes, it is also
pertinent for estate and gift tax purposes. Although the example involved in the
Revenue Procedure involved artwork, the Rev. Proc. states that similar information
should be provided for other types of property. The required information contained in
the appraisal is as follows:
a summary of the appraiser's qualifications;

- a statement of the value and the appraiser's definition of the value he has obtained;

- the bases upon which the appraisal was made, including any restrictions, understandings, or covenants limiting the use or disposition of the property;

- the valuation date of the property; and

- the signature of the appraiser and the date the appraisal was made.

11. Where art objects are concerned, and particularly paintings, the appraisal should include the following elements:

- a complete description of the object, indicating the size, the subject matter, the medium, the name of the artist, the approximate date the work was painted, and the interest transferred;

- the cost, date and manner of acquisition;

- a history of the item, including proof of authenticity, such as a certificate of authentication if such exists;

- a photograph of sufficient size and quality to identify the subject matter, preferably a ten by twelve inch or larger print;

- a statement of the factors upon which the appraisal was based, such as sales of other works by the same artist, particularly on or around the valuation date;

- quoted prices and dealers' catalogues of the artist's work or of other comparable artists;

- the economic state of the art market at or around the time of valuation;

- a record of any exhibitions at which the particular art object had been displayed; and
12. In Smith Est. v. Commissioner, 57 T.C. 650 (1972), acq. 1974-2 C.B. 4, aff'd, 510 F.2d 479 (2d Cir. 1975), cert. denied, 423 U.S. 827 (1975), the Tax Court listed the criteria on which it relied to value, for estate tax purposes, a large number of pieces of sculpture owned by an artist at his death. After recognizing that a large block of the artist's work placed on the market at one time would necessarily depress the fair market value of the works involved (similar to the blockage concept in securities), the court listed the following factors:

- the decedent's reputation as a sculptor;
- the acceptability of the medium and the style in which the artist worked;
- the size, period, and quality of the particular works involved;
- the tendency of the artist to work in a series, and whether the individual items constituted a complete series;
- the number of sales in the 25 years preceding the artist's death, and the prices paid immediately before and after his death; and
- the inconvenient location of the items and the feasibility of their being transported to an area easily accessible to potential buyers.

13. Note: In a case involving the valuation of large tracts of land located in Arkansas, the Tax Court relied mainly on the testimony of the IRS' expert witness. Some of the factors considered by the Government's witness in reaching the price per acre were:

a. the size of the acreage involved and the problem involved in selling such a large amount of land;
b. the number of tracts involved;
c. the accessibility of the tracts;
d. the site potential;
e. the volume of timber present and its state of growth;
f. sales of comparable land; and
g. the highest and best use of the land.

The expert also took into account the fact that a person would need a large sales organization to sell the tracts and that the titles to all the and were not secured. The court also considered the prices that were paid per acre in the sales made after the decedent’s death as being significant in affirming the expert’s determination. *Broadhead Est. v. Commissioner*, T.C. Memo 1972-195 (1972), reconsideration granted, T.C. Memo 1973-222 (1973).

14. *Comment:* An important decision for all taxpayers in valuation cases is that of the Sixth Circuit in *Akers v. Commissioner*, 798 F.2d 894 (6th Cir. 1986), rev’g T.C. Memo 1984-208 (1984), on remand, T.C. Memo 1992-476 (1992). There, the court rejected the Tax Court’s compromise valuation of property donated to charity because it failed to explain the process it used to value it. The Sixth Circuit refused to accept the Tax Court’s practice of picking at random “any number that happens to lie . . . between the Commissioner’s valuation and the taxpayer’s.” The court stated that the valuation must be substantiated both for the litigants and for the purpose of any subsequent appeals.

15. Be aware of how the IRS auditor will approach the issue of valuation. A good source of information may be found in the Internal Revenue Manual pertaining to both Examination and Appeals, as well as in the IRS Valuation Training course book. Located in the Appendices to this outline you will find relevant excerpts from both resources as they pertain to challenging the valuation of different asset classifications.

V. Discovery of Expert Witnesses in U.S. Tax Court

A. Background

Historically, litigants in the Tax Court were prohibited from taking discovery depositions of their opponents' experts. Instead, a party’s discovery options were limited to serving interrogatories on an opposing party pursuant to Tax Court Rule 71(d). The ability to obtain information through interrogatories about an expert witness that an opposing party expects to call at trial remains available. However, effective July 1, 1990, the Tax Court adopted Tax Court Rule 76 which permits the limited use of depositions. Official Notes to Tax Ct. R. 76, 93 T.C. 910-13 (1989).

B. Discovery of Information by Interrogatories

Written interrogatories may be used to require a party to provide information as to any expert witnesses expected to be called at trial. Interrogatories may request a party to disclose:
(i) each person whom that party expects to call as an expert witness at trial, giving the name, address, and occupation of the expert together with a statement of such expert’s qualifications;

(ii) the subject matter and substance of facts and opinions to which such expert is expected to testify; and

(iii) a summary of the grounds for each opinion of such expert. Tax Ct. R. 71(d)(1).

In lieu of providing the foregoing information in the form of answers to interrogatories, the responding party may provide the proponent a copy of an expert witness report containing such information. Id. Under Tax Ct. R. 143(f), an expert witness report is required even if responses to the proponent’s request for the information identified in Tax Ct. R. 71(d)(1) are provided in the form of answers to interrogatories.

C. Depositions of Experts

1. Tax Court Rule 76 allows a deposition to be taken of an opposing party’s expert witness in certain limited circumstances. The deposition of an expert witness can occur either by consent of the parties or pursuant to a compulsory deposition. If the deposition is consensual, the provisions of Tax Court Rule 74 apply. Tax Ct. R. 76(a)(1). In the case of a compulsory deposition, the procedural provisions of Tax Court Rule 76 govern, including the limitation that nonconsensual depositions are considered “an extraordinary method of discovery.” Id. 76(a)(2).

2. Rule 76 limits the scope of the examination of the expert to the following areas of inquiry:

   (i) knowledge, skill experience, training, or education that qualifies the witness to testify as an expert;

   (ii) the expert’s opinion;

   (iii) the facts or data supporting the expert’s opinion; and

   (iv) any analysis that demonstrates how the conclusion of the expert resulted from the underlying facts or date. Id. 76(b).

3. To institute the compulsory deposition process, a motion must be filed by the party desiring to depose an expert witness. Id. 76(d)(1). The motion must be filed after a notice of trial has been issued or the case has been assigned to a judge and must be completed within the general discovery cutoff deadline, i.e., 45 days prior
to the call of the trial calendar for the case. Tax Ct. R. 76(c), and 70(a)(2). The motion
must include the following matters:

(i) The name and address of the witness.

(ii) A description of any books, papers, documents, or other things to be produced at the deposition.

(iii) A statement of the issues to which the expert's testimony relates and the reasons for deposing the witness.

(iv) The proposed time and place for the deposition.

(v) The officer before whom the deposition is to be taken.

(vi) Any provision as to the payment of costs and fees.

(vii) If the deposition is to be videotaped, the name and address of the videotape operator and the operator's employer. Tax Ct. R. 76(d)(2).

If the deposition will be taken using written questions, a copy of the questions to be propounded must be attached.

4. After the motion is filed, the opposing party has a 15-day period after service of the motion in which to object or otherwise respond to the motion. Id. 76(d)(3). Unless the parties agree by stipulation for the handling of fees and expenses of the expert witness, such fees and expenses typically will be allocated to the party taking the deposition. Id. 76(g)(2).

D. **Expert Witness Reports**

1. Under Tax Court Rule 143(f), an expert witness is required to prepare a written expert witness report setting forth the expert's qualifications and the expert's opinion and facts or data on which the opinion is based. The report should also state in detail the reasons for the expert's conclusions. Tax Ct. R. 143(f)(1).

2. An expert witness report is required to be made available to the Court and the opposing party for each expert called as a witness. A copy of the report must be furnished to the Court and the opposing party at least 30 days before the call of the trial calendar on which the case appears. However, the deadline for submitting the expert witness report under Tax Ct. R. 143 does not extend the time in which a party must answer interrogatories to the extent such party decides to furnish a copy of the expert witness report in lieu of answers to interrogatories. Id. 71(d)(2). Typically, the
parties will voluntarily and simultaneously exchange expert witness reports before the 30-day limit under Tax Court Rule 143(f). See CCDM (35)5(15)1(2) (Mar. 26, 1991).

3. In appropriate cases, the court may order that the deposition transcript of an expert witness serve as the expert witness report required by Tax Court Rule 143(f). Tax Ct. R. 143(f)(3), 76(e)(1). To utilize the deposition transcript in lieu of the expert witness report, the proponent of the expert witness must apply to the Court by written motion. Tax Ct. R. 76(e)(1).

E. Discovery of Expert Witnesses Not Expected to Testify

Although the discovery rules applicable in United States district courts and the Court of Federal Claims provide, in limited instances, for the discovery of the opinions held by experts who have been retained by another party in anticipation of litigation or preparation for trial, but who are not expected to testify, the Tax Court Rules contain no similar provision. See Fed. R. Civ. P.26(b)(4)(B); Fed. Cl. R. 26(b)(3)(B) (discovery is allowed only "upon a showing of exceptional circumstances under which it is impracticable for the party seeking discovery to obtain facts or opinions on the same subject by other means").

VI. Expert Witness Testimony in Tax Court

1. An expert witness must provide the Tax Court and the opposing party with a written expert witness report. See CCDM 35(641) to 35 (649) for a discussion of the procedures followed by IRS Chief Counsel attorneys in selecting and contracting with an expert witness.

2. The report must set forth:

   a. the qualifications of the witness;
   b. the expert's opinion;
   c. the underlying facts supporting the expert's opinion; and
   d. the reasons for the expert's conclusion. Tax Ct. R. 143(f)(1). Tax Court Rule 143(f)(1) was amended effective August 1, 1998, to clarify that the expert witness reports are not to be filed with the Court until after the case is calendared for trial or has been assigned to a judge or special trial judge.

3. The expert report must be submitted not later than 30 days before the call of the trial calendar on which the case appears. Some judges now require exchange of expert reports 90 to 120 days prior to calendar call, with rebuttal reports to
be filed 30 to 45 days prior to trial. The intended purpose of this accelerated schedule is to encourage settlements.

4. If an expert witness report is not prepared and provided, the witness’ testimony may be excluded, unless the failure is shown to be due to good cause and the failure does not unduly prejudice the opposing party, such as by significantly impairing the opposing party’s ability to cross-examine the expert witness or denying the ability to obtain rebuttal evidence. Tax Ct. R. 143(f)(1). See Yates v. Commissioner, 92 T.C. 1215, 1228 (1989) expert who failed to provide timely report was not permitted to testify on direct, but only in rebuttal of opposing party’s experts); Keogh v. Commissioner, 75 AFTR2d 1698 (2d. Cir. 1995) (unpublished opinion; upholding exclusion of expert witness where report filed three days prior to trial). Malachinski v. Commissioner, 268 F.3d 497 (7th Cir. 2001) (affirming Tax Court’s exclusion of direct testimony of expert as to factual basis for her conclusion where it was not previously set forth in written report).

5. Ordinarily, the expert’s written report is intended to serve as the direct testimony. However, additional testimony with respect to the report will be permitted to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court. Tax Ct. R. 143(f).

6. The Court has discretion to not require an expert witness report if a timely request is made. Id. 143(f)(1). However, the Court ordinarily will not grant such a request where the expert witness’ testimony is based on third-party contacts, comparable sales, or other detailed, technical information. Such a request may be granted, for example, where the expert witness testifies only with respect to industry practice or in rebuttal to another expert report. Id. 143(f)(2).

7. The Tax Court Rules do not specifically provide for the appointment of an expert witness by the Court. See Fed. R. Evid. 706. However, the Court has, on occasion, directed one party to procure an expert witness at the party’s expense. Holland v. Commissioner, 835 F.2d 675 (6th Cir. 1987) (upholding Tax Court order, but finding it “unusual” but in general compliance with Fed. R. Evid. 614 which allows court to call witnesses on its own motion). See also Argo Science Co. v. Commissioner, 58 TCM (CCH) 1093, 1103 (1989), aff’d, 927 F.2d 213 (5th Cir. 1991), reh’g denied, 934 F.2d 573 (5th Cir. 1991). More recently, the Tax Court used two court-appointed experts in Bank One Corporation v. Commissioner, Docket Nos. 5759-95, 5756-97, where the valuation of financial derivatives under Section 475 is involved. Under the stipulated terms of the arrangement, the two experts are permitted to confer with each other ex parte, they are not subject to discovery except by written interrogatories, and their fees are shared equally by the parties. Of particular interest is the statement in the stipulation that “[n]othing in this stipulation should be construed as respondent’s acquiescence to this procedure as a matter of tax litigation policy or that respondent would agree to a similar procedure in any other case.”
8. Although it may not arbitrarily disregard the testimony of an expert witness, *Wekhausen v. Commissioner*, 56 TCM (CCH) 299 (1988), the Tax Court has broad discretion in determining the weight to be accorded to such testimony. *Parker v. Commissioner*, 86 T.C. 547, 562 (1986). *See Utilicorp United, Inc. v. Commissioner*, 104 T.C. 670 (1995) (IRS valuation expert permitted to testify despite contention that state law was violated). In considering expert testimony, the Tax Court, as the trier of fact, can use its best judgment and adopt portions of the testimony and reject others. *Estate of Rodriguez v. Commissioner*, 56 TCM (CCH) 1033, 1038 (1989). *See also Lukens v. Commissioner*, 945 F.2d 92 (5th Cir. 1991) (Tax Court discretion upheld to disregard portions of expert report and formulate its own valuation method); *Silverman v. Commissioner*, 538 F.2d 927, 933 (2nd Cir. 1976); *Chiu v. Commissioner*, 84 T.C. 722, 734 (1985); *IT&S of Iowa, Inc. v Commissioner*, 97 T.C. 496, 508 (1991); *Estate of Mitchell v Commissioner*, 74 TCM (CCH) 872 (1997) rev'd and remanded on this point, 250 F.3d 696 (9th Cir. 2001); *Estate of Fleming v Commissioner*, 74 TCM (CCH) 1049 (1997).

9. In this regard, the Tax Court has been particularly vocal in criticizing the testimony of expert witnesses who appear to be partisan advocates, particularly in valuation cases. The Court has not identified specific factors that establish such a finding, but the cases in which this criticism has been made fall into several identifiable categories.

a. when the expert’s methodology is materially flawed by disregarding relevant factors or giving undue weight to certain factors;


b. when the expert’s report or testimony reflects a stubborn adherence to a particular methodology or otherwise indicates a lack of objectivity;
Sundstrand Corp. v. Commissioner, 96 T.C. 226, 371 (1991) ("result-oriented" opinion based on questionable assumptions by expert who was "unresponsive, evasive, and equivocal on examination"); Messing v. Commissioner, 48 T.C. 502, 512 (1967) cautioning against "overzealous efforts . . . to infuse a talismanic precision to valuation"); Mooneyham v. Commissioner, 61 TCM (CCH) 2445, 2447 (1991) (expert's opinion should be "based on objective information that he independently has available or secures, not information blatantly foisted on him by a party's representative"); Estate of Hatchett v. Commissioner, 58 TCM (CCH) 801, 808-09 (1989) (expert ignored approach recommended by American Institute of Real Estate Appraisers); Williamette Indus v. Commissioner, 64 TCM (CCH) 202, 212 (1992) (lack of objectivity "evidenced by the adversarial stance he took early in the proceedings and never abandoned").

- c. the expert's opinion and explanation displays an argumentative or disparaging tone;

Estate of Hatchett v. Commissioner, 58 TCM (CCH) 801, 809 n3 (1989) (expert testified that "I would say that in 18 and a half years of real estate appraisal experience the inclusion of these sales is the most absurd, unethical thing I've seen a real estate appraiser do"); A. Ross Winans Grantor Trust v. Commissioner, 58 TCM (CCH) 884, 903 (1989) ("argumentative and biased analysis"). See also Vangeloff v. Commissioner, 64 TCM (CCH) 660, 667 (1992) (expert testified that he was hired for the purpose of limiting the taxpayer's claimed deduction); Johnson v. Commissioner, 63 TCM (CCH) 3197, 31979-5 (1992), reh'g granted on another issue, 65 TCM (CCH) 2465 (1993); Williamette Indus v. Commissioner, 54 TCM (CCH) 616, 624 (1987) (opposing experts labeled as members of the "flat earth society").

- d. the expert opines in areas in which he or she has no particular expertise or makes legal conclusions;


- e. where the expert declines to reveal the sources for his or her opinions; Seagate Tech v. Commissioner, 102 T.C. 149, 265, 271 (1994); and

- f. where the opinion varies widely from the other experts' opinions in the case.

No one of the above factors will be dispositive, but the presence of one or two will almost certainly result in the opinion being given little weight, and the confluence of multiple factors will likely result in the exclusion of the expert's testimony. See Estate of Halas v. Commissioner, 94 T.C. 570; 578 (1990) (citing the Principles of Appraisal Practice and Code of Ethics, the Court noted that "an appraiser has a duty to the Court that exceeds his duty to his client"). See also Hamblen, The Changing Tide of Tax Court Litigation: Large Case Management, 14 Va. Tax Rev. 1, 10 (1994) ("experts would do well to remember that their sole purpose is to assist the Court").

9. The Tax Court also has criticized experts who have a conflict of interest. In this regard, the Court has held that where an expert has had a prior relationship with an opposing party, the expert will be disqualified if he or she received confidential information concerning the party seeking disqualification as a result of his or her prior relationship with that party. Estate of Halas v. Commissioner, 58 TCM (CCH) 280 (1989), as supplemented by 94 T.C. 570 (1990). If such showing is not made, the expert will not be disqualified. See Estate of Clapp v. Commissioner, 47 TCM (CCH) 504, 505 n5 (1983) (expert unaware of his partner's previous appraisal). See generally FPL Group, Inc. v. Commissioner, T.C. Memo 2002-92 (2002) (testimony of in-house attorney as to state regulatory law was inadmissible for reason that "testimony that expresses a legal conclusion and does not assist the Court is not admissible").

VII. Business Valuation Theory and Principles

A. Overview

1. The three generally accepted approaches to business valuation are the income approach, the asset-based approach and the market approach. These three approaches are similar to the income, cost and market approaches used in real estate valuation.

2. The value of any business, from a financial point of view, is equal to the present value of the expected future economic benefits to the owners. The discount rate used in the calculation of present value is equal to the cost of capital that would be required to attract investment.
a. This highlights the forward-looking nature of the valuation process. The past is irrelevant, except to the extent it helps us forecast the future. Development stage companies would be worthless if the past was all that mattered.

b. Because two reasonable appraisers can have entirely different views about the future, they may reach value conclusions that differ dramatically. There is much truth to the statement that valuation is as much art as science.

c. The discounted future benefits method determines value by taking a stream of future economic benefits (such as earnings or cash flow) and discounts them to the present at an appropriate discount rate. To use this method, the appraiser must estimate future benefits and determine the appropriate discount rate to apply to them.

d. The capitalization of benefits method estimates value by taking a representative economic benefit level and dividing by a capitalization rate to convert the benefit to value. The capitalization rate is equal to the discount rate (discussed above) less the projected growth rate of the economic benefits.

3. The market comparison approach draws on actual transactions in the market place to determine value. Value is estimated by using one or more methods to compare the subject company to similar businesses or securities for which market values are available.

a. When utilizing the market approach to valuation, the underlying expectations of investors as to future returns and risk are inherently incorporated into price-to-earnings multiples, capitalization rates and other value measures.

b. The market value data for other companies may come from completed acquisition transactions, stock market data for companies which are actively traded, or from private placement transactions. Regardless of the source of data, the objective is to estimate the value of the subject company based upon the relationships of market value to the underlying characteristics of the guideline companies.

4. The asset-based approach to valuation looks to the value of the underlying assets of a business. The sum of the value of all assets, including intangible
assets such as goodwill, less the value of all liabilities, contingent or otherwise, yields an estimate of the value of the entity.

a. The asset-based approach is generally not as relevant as an earnings-based approach when valuing a going concern business. Buyers of going concern businesses are more interested in future cash flows, earnings and dividends rather than asset values. This is especially true for minority owners who lack the ability to sell or liquidate an entity’s assets.

b. As a general rule, the asset-based approach is more appropriately suited to holding companies, such as real estate investment companies, or companies where liquidation is imminent.

5. Many owners (e.g., shareholders, limited partners and members) have no direct claim on an entity’s assets.

a. As a result, the value of their fractional ownership interest may be worth more or less than a pro rata share of the value of the entity.

6. Ownership interests in closely-held entities rarely enjoy the liquidity of interests that are actively traded on stock exchanges or in the over-the-counter market.

a. Lack of marketability, or the inability of an owner to quickly convert his interest into cash, is a factor which affects value.

7. Minority owners lack control over business decisions and, therefore, are usually worth less than the proportionate share of the assets to which they attach.

a. Minority owners generally lack the right to elect a majority of directors, appoint management, determine management compensation and perquisites, make acquisitions or sales, make distributions or determine the future direction of the business.
b. The minority interest discount and the lack of marketability discount are separate but interrelated concepts. Controlling interests in a business may suffer from lack of marketability, but generally not to the same degree as minority interests.

B. General Valuation Discounts

1. Minority interest (lack of control) discount

a. Rev. Rul. 93-12 CB 202 dramatically increased the use of minority interest discounts among planners. Previously, the Internal Revenue Service (the "Service") routinely disallowed minority interest discounts in the case of family-owned businesses.

b. The immense popularity of family limited partnerships (FLPs) and limited liability companies (LLCs) as estate planning vehicles was spawned by Rev. Rul. 93-12. Many advisors and appraisers take the view that cash and marketable securities "wrapped" into a family limited partnership may be discounted by 40% or more for federal transfer tax purposes.

c. The Service has attempted to use arguments other than family attribution to shut down FLPs as discount planning vehicles, but a statutory change may be needed to limit their attractiveness. The typical challenges by the Service are discussed later in this outline. However, the simple truth is that minority interests in FLPs really are worth less than the pro rata share of the underlying assets.

d. The level of control inherent in any business interest extends from absolute control to the absolute lack of control. See Exhibit C.
2. Lack of marketability discount

a. Ownership interests in closely held entities do not trade in an active and efficient market. The inability of an owner to readily convert his interest into cash makes his interest less valuable than an identical interest which is readily convertible into cash.

b. Numerous empirical studies on this subject have been conducted over the past 30 years and these studies have generally supported discounts of 25% to 50% for lack of marketability. For the restricted stock of publicly traded companies, discounts may be falling due to the availability of derivatives which limit risk during the restricted period. In addition, the holding period under SEC Rule 144 has been decreased from two to one year. See Exhibit B for a further discussion of lack of marketability discounts.

3. Built-in capital gains tax

a. More than 10 years after the repeal of General Utilities, the Tax Court has handed down a decision permitting the taxpayer to consider built-in taxes in the valuation of stock in a C corporation. *Estate of Artemus D. Davis v. Commissioner*, 110 T.C. 530 (1998). A portion of the built-in capital gains tax liability was included as a part of the lack of marketability discount.

b. The Service had repeatedly argued that built-in capital gains taxes were not a factor unless liquidation was imminent or, alternatively, that the tax could be avoided by converting a C corporation to S corporation status and waiting 10 years before selling its assets. Judge Chiechi pointed out what all merger and acquisition advisors know, that buyers and sellers would take low-basis assets into account when negotiating price.

c. Additionally, the Second Circuit vacated a Tax Court Decision (T.C. Memo 1997-483) disallowing a reduction in the value of stock in a real estate C corporation for the potential capital gains tax liability. *Eisenberg v. Commissioner*, 155 F.3d 50 (2d Cir.1998). The Second Circuit stated that “a hypothetical willing buyer today would likely pay less for the shares of a corporation because of the buyer’s inability to eliminate the contingent tax liability,” and remanded the case in order for the Tax Court to
ascertain Mrs. Eisenberg's gift tax liability. The Second Circuit also noted that the full amount of the potential capital gains is not necessarily what should be subtracted from the fair market value of the underlying real estate.

d. Partnership's and LLC's without a valid Section 754 election in place may also be eligible to recognize a discount for a built-in capital gain tax liability as may Shareholders in S corporations.

4. Fractional interest discounts

a. The discount applied to an undivided interest in an asset, such as real estate. Much like a minority owner, a co-owner of property lacks the ability to take certain actions.

b. Co-owners have the right to file suit to partition the jointly owned property. The Service has generally tried to limit the discount to the cost of the partition suit. However, because of the cost of the suit and the uncertainties and the delays involved, the courts have recently been more receptive to the larger discounts being put forth by co-owners.

5. Other discounts

a. Other common discounts applicable to closely-held businesses include: (i) dependence upon a key employee, (ii) product obsolescence, (iii) dependence upon a key customer or supplier, (iv) lack of geographic or product diversification, (v) high cost of capital or excessive debt leverage, (vi) unfavorable contracts and (vii) under-performing or nonproductive assets.

b. While the above discounts exist at many closely held companies, they are not tools to be implemented as a part of the estate planning process. Lack of marketability and minority interest discounts are by far the most commonly utilized discounts in the estate planning process.

VIII. Recent Developments in Business Valuation

A. Peter S. Peracchio v. Commissioner, T.C. Memo 2003-280 (September 25, 2003)

1. A case involving the calculations of discounts for lack of control and marketability for a FLP holding only cash and marketable securities. The taxpayer formed a FLP in 1997 with $2,008,370 of cash and marketable securities. Immediately after formation, the taxpayer sold and gifted limited partner interests to a family trust and his son. In his
1997 gift tax return, the taxpayer claimed a combined discount of 40%. Although the IRS initially challenged any discount, at trial the IRS argued for a discount of 4.4% for lack of control and 15% for lack of marketability. The Court was relatively unhappy with the testimony of all of the expert witnesses on both sides and arrived at a 6% minority discount and a 25% discount for lack of marketability.


1. Clarissa Lappo and her daughter formed a FLP in 1996, funding it with real estate and marketable securities consisting mostly of municipal bonds. The IRS challenged the valuation of two gifts of limited partnership interests in 1996, in particular the minority interest discount related to the real estate and overall lack of marketability discount. Both the IRS and taxpayer expert witness agreed that REITs were the appropriate starting point for the minority interest discount applicable to the real estate, but disagreed in their adjustments. After reviewing the evidence presented on price to net asset value ratios for REITs and the differences between publicly traded REITs and private partnership interests, the Court arrived at a 19% minority interest discount for the real estate. For the overall marketability discount, the Court analyzed the raw data in studies performed by Dr. Bajaj and Hertzel & Smith, as well as considerations raised by both appraisers, to arrive at a final marketability discount of 24%.

C. Johann and Johanna Hess, T.C. Memo 2003-251 (August 20, 2003)

1. This case involved a dispute over the value of the shares of a closely held C corporation. In 1995, Mr. and Mrs. Hess gifted shares in Hess Industries, their closely held C corporation, assigning a value of $120,000 to each of the ten shares gifted. The IRS disagreed, asserting a value of $253,000 per share in the deficiency notice. Previously, a retiring shareholder was paid $4,000,000 for 20 shares, an eight-year non-compete, and a three-year employment agreement. At trial, the taxpayer appraiser asserted a $128,000 value, while the IRS valuation expert asserted a $269,000 value. The taxpayer appraiser used a DCF analysis and the market approach, although the Court disagreed with an after-the-fact adjustment for reserves in the DCF approach, and the minority interest discount taken in the market approach since the market approach was based on minority transactions. The IRS appraiser based his value on a weighting of net asset value, the prior stock transaction, the shareholder agreement and the guideline public company method. The Court, agreeing with some, but not all, of the arguments of both sides, decided on a value of
$200,000 per share, just slightly higher than the average of the two appraisals.

D. **Albert and Christine Hackl v. Commissioner**, 335 F.3d 664 (7th Cir. 2003)

1. The Tax Court ruled in Hackl that gifts of LLC interests were gifts of future interests and therefore did not qualify for the annual gift tax exclusion. The Hackls' argument on appeal was that a gift is not a gift of a future interest if the donors give up all of their legal rights and that their position reflected the meaning of "future interest" in the statute. The 7th Circuit upheld the decision, noting that even though the voting shares that the Hackls gave away had the same legal rights as those they retained, the LLC Operating Agreement restrictions on transferability of the shares meant that they were essentially without immediate value to the donees. The 7th Circuit also noted that the onus in this case is on the taxpayers, and the Hackls failed to show that their transfers qualify for the gift tax exclusion.


1. At her death on September 15, 1997, Helen Deputy owned an interest in a FLP that owned 19.99% of Godfrey Conveyer Co., Inc., a recreational boat builder. The IRS challenged the valuation of gifts made in May and July of 1997 as well as the estate valuation. Specifically the IRS disagreed with the taxpayer on the value of Godfrey, but agreed that the value determined by the Tax Court as of September 17, 1997 would also be used for the prior partnership gifts. The Tax Court sided with the IRS expert on the notion that the income approach was the sole appropriate approach for this valuation. The Court also sided with the IRS expert's 10% capitalization rate, including a negative 5.2% industry risk, citing the IRS expert's use of real data and calling the taxpayer's assumptions subjective. The IRS expert applied no minority discount reasoning that the capitalized earnings approach would result in treating all interests in the entity equally, but did determine a 25% discount for lack of marketability based on two restricted stock studies. The taxpayer expert arrived at a combined discount of 44% based on a matrix constructed by his firm that assigned a numerical value to a number of qualitative issues, including attributes of control and company outlook. Although the Tax Court disagreed with the discounts of both parties, it did use the matrix as a guide, concluding a 30% combined discount was appropriate.


1. This case was remanded from the Fifth Circuit. Shortly before his death in 1994, Mr. Strangi transferred 98% of his assets to a family limited partnership (SFLP). In 2000, a sharply divided Tax Court held:
(1) SLFP was valid under state law and would be recognized for estate tax purposes, (2) I.R.C. §2703(a) did not apply to the partnership agreement, and (3) the transfer of assets to the partnership was not a taxable gift. The IRS appealed to the Fifth Circuit and requested to amend its claim to add the §2036 claim, which would require the estate to include the assets transferred by Mr. Strangi to SFLP rather than just his partnership interest in SFLP. The Fifth Circuit disagreed with the Tax Court’s denial of the IRS’s request and reversed the Tax Court on that issue. On remand, however, the Tax Court determined that the transfers to SFLP met the test under both §2036(a)(1) and §2036(a)(2) and ruled the full amount of the assets transferred was to be included as part of decedent’s estate, relying on Estate of Harper v. Commissioner, T.C. Memo 2002-121.


1. This case involves the determination of a discount for lack of marketability and control in a family limited partnership and the amount of a charitable donation of limited partnership interests. The Tax Court rejected pre-IPO studies and some restricted stock studies, ultimately siding with the IRS in using a variant of the restricted stock approach, termed the private placement approach, to determine the marketability discount. Also, the Court determined that the amount of the charitable donation should be based on the fair market value determined by the taxpayer’s appraiser and not the amount determined pursuant to a formula clause that kicked in as the result of an audit adjustment.


1. Natalie M. Leichter died in 1995, owning 100% of Harlee International, Inc., a California S corporation that imported and distributed waterbeds and futons. An appraiser for the estate determined the fair market value of Harlee to be $2,091,750 and the IRS determined a value of $2,718,258 (lowered to $2,150,000 at trial) for during examination of the estate. The estate claimed that errors were made during the original valuation and submitted new valuations of $863,000 and $400,000. However, the Court called the errors “orthographic” and gave these new valuations no weight. The Court determined the value of $2,091,750 reported on the decedent’s tax return was proper.

I. Raymond J. Martin, et al., Plaintiffs v. Martin Bros. Container & Timber Products Corp., et al., Defendants, United States District Court for the Northern District of Ohio, Western Division, Case No. 3:00CV7642

1. The case involved disputes over the proper level of discounts for lack of control and marketability and the treatment of the tax on built-in
gains for a C corporation. The Court accepted a 15% discount for lack of control and a 30% discount for lack of marketability suggested by an appraiser hired jointly at the suggestion of the Court. However, the Court disagreed with all three appraisers on the built-in gains tax adjustment, ruling that the tax should be recorded at its present value, not the full amount of the tax at the valuation date. The Court cited Estate of Pauline Welch v. C.I.R., 208 F.3d 213, 2000 WL 263309, **4 (6th Cir. 2000) and Eisenberg v. Commissioner, 155 F.3d 50, 57 (2nd Cir. 1998).

J. David A. Kimbell Sr., et al. v. United States, No. 7:01-CV-0218-R, United States District Court for the Northern District of Texas

1. The case concerns the valuation of a family limited partnership. Ruth Kimball created the FLP two months before her death in 1998, with her revocable living trust as a 99% limited partner and a Texas LLC as a 1% limited partner. Ruth owned 50% of the LLC and her son, David, owned the other 50%. David was also a co-trustee with Ruth of the revocable trust and manager of the LLC. Ruth, through her 99% ownership of the limited partnership interests, retained the right to remove the general partner since the FLP agreement provided that 70% in interest of the limited partners could remove the general partner. The estate and the IRS differed on their valuations of the partnership and the estate sued for a refund after paying the disputed taxes. The Court held under IRC §2036, that an estate must include the value of assets that had been transferred to a partnership instead of the partnership interest actually owned by the estate. The Court determined that their was no bona fide sale and that the decedent retained the power to designate who would benefit from the partnership, negating the two exceptions to inclusion under IRC §2036.

K. Estate of Thompson v. Commissioner, T.C. Memo 2002-246 (September 26, 2002) (On appeal to the 3rd Circuit)

1. Two years before his death, Theodore Thompson formed two family limited partnerships using the "Fortress Plan," transferring substantially all of his investment assets to these partnerships. However, the partnerships were set up so that Mr. Thompson received distributions that he used to make gifts to family members and pay his own personal expenses. The IRS challenged the estate valuation, claiming that the partnerships lacked economic substance and should be ignored for transfer tax purposes. The IRS also claimed that since Mr. Thompson retained economic benefit and control of the transferred assets, §2036(a) should apply. The Court concluded that the partnerships did have economic substance, but that §2036(a) should apply since Mr. Thompson did retain economic benefit of the property.
Therefore, the full date-of-death value of the assets transferred were included in the gross estate pursuant to §2036(a).


1. This case involves the valuation of privately held wholesaler and retailer of prepackaged food products for gift tax purposes in 1992 and charitable donation purposes in 1994. For the 1992 valuation the Court accepted the IRS expert’s weighting of the market and income approaches as well as his methodology for calculating freely-traded value. The Court sided with the taxpayer expert on the discount for lack of marketability however, citing the detailed analysis of restricted stock and pre-IPO studies and allowing discounts of 40% in 1992 and 45% in 1994. Both sides agreed on a 5% discount for lack of voting rights. Finally, since the IRS did not present expert testimony to support its challenge to the 1994 valuation, the Court accepted the value calculated by the taxpayer expert.

M. Estate of Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002)

1. The Fifth Circuit reversed and remanded Estate of Beatrice Dunn v. Commissioner, T.C. Memo 2000-12 (January 12, 2000), criticizing both the IRS and the Tax Court’s opinions concerning the valuation of Dunn Equipment, a C corporation of which the decedent owned 62.96%. During the original trial, the IRS argued that no discount should be allowed for the trapped-in gains and no weight should be assigned to the lower income approach value. Even though the IRS presenting only an accounting expert to argue against the estate and not a valuation expert to support its value, the Tax Court sided in part with the IRS, accepting a 34% tax rate on the trapped-in gain and allowing only 5% of the trapped-in gains as a reduction to the net asset value. Additionally, the Tax Court assigned weights of 65% and 35% to the asset approach and income approach, respectively. On remand, the Fifth Circuit criticized the Commissioner’s “extreme and unjustifiable trial position” and the “legal, logical, and economic non sequitur” assignments of the Tax Court’s assignments of weights. The Fifth Circuit concluded that 100% of the tax on the trapped-in taxable gain for a C corporation must be subtracted under the asset approach and that 85% of the final value should be determined using the income approach, with a 15% weight assigned to the asset approach. Additionally, the Fifth Circuit told the Tax Court to entertain any claim that the taxpayer might make under I.R.C. §7430, which awards certain costs and fees to the taxpayer.

N. Estate of Bailey v. Commissioner, T.C. Memo 2002-152 (June 17, 2002)
1. At his death in 1995, Lewis Bailey owned a 25% interest in C&L Bailey, Inc., which owned and operated a motel in Arkansas and one in California; additionally, Mr. Bailey was a beneficiary of a QTIP trust owning 25% of the company. The Court disagreed with several aspects of the taxpayer expert's testimony, including the use of a "quick sale value" discount, the inclusion of $145,000 shareholder liability treated as debt (saying the record did not substantiate the liability), and the appropriateness of his reliability on pre-IPO studies in determining the discount for lack of marketability. In the end, the Tax Court sided with the IRS expert's net asset value despite the fact that it contained little support for assumptions used in calculating the built-in gains tax, but let stand the 50% combined discount for lack of control and marketability claimed in the original estate tax return.

O. Kerr v. Commissioner, U.S. Court of Appeals for the Fifth Circuit, No. 00-60903 (June 10, 2002)

1. The Kerr's formed two Texas FLP's in 1993 and assigned a portion of each to their children. The partnership agreements restricted dispositions of partnership interests and the ability to dissolve the partnerships. In 1994, the Kerr's each created a GRAT, transferring to it a 44.5% limited partnership interest. The IRS disagreed with the valuation as filed in gift tax returns and claimed that the liquidation restrictions in the partnership agreements were applicable restrictions under section 2704(b) and thus should have been disregarded in the valuations. The Tax Court held that the Kerr's transferred limited partnership interests to the GRATs, and rejected the argument that they transferred only assignee interests. The Tax Court also held that section 2704(b) did not apply since the partnership agreements' liquidation restrictions weren't applicable restrictions under section 2704(b)(3)(B) and reg. section 25.2704-2(b), thus allowing a discount for lack of marketability. The Fifth Circuit upheld the ruling of the Tax Court.

IX. Family Limited Partnerships and Limited Liability Companies

A. Since Rev. Rul. 93-12 in which the Service abandoned its position on family attribution in the determination of fair market value, the FLP has grown rapidly in importance as an estate planning tool. The FLP is extremely attractiveness to planners for both tax and nontax reasons.

1. Nontax. The older generation can indirectly transfer assets to the younger generation without losing control while also protecting the assets against creditors. Additionally, gifting of securities is easier than direct gifts of fractional interests in property and economies of
scale, diversification, competent management of assets and retention of assets within the family unit are easier to accomplish.

2. **Tax.** As pass-through entities, FLPs avoid double taxation and, in general, valuation discounts for limited partners of FLPs are greater than for co-owners of fractional interests.

B. The Service continues to aggressively attack the use of FLPs as a means by taxpayers to create valuation discounts for cash, marketable securities and other assets not used in the active conduct of a trade or business. Their avenues of attack have included:

1. Sham transaction or device. Attempting to invalidate or ignore the entity claiming that it was created solely for tax avoidance purposes, was defective under state law or was without substance for federal transfer tax purposes.


C. Strangi has prompted a number of estate planners to consider what to advise clients to do differently when creating FLPs and LLCs, or what should be done, if anything, about FLPs and LLCs created in the past. As an aid in this analysis, the following is a list of “badges” of the kind of retained interest or control that in certain combinations could create estate tax problems under Strangi and previous cases:

1. Control of the entity by the transferor (in the facts underlying Strangi, control was exercised through Mr. Strangi’s son-in-law as attorney-in-fact).

2. Presence of a power of attorney, deathbed planning, or incapacity when the entity is created

3. Transfer of substantially all of the transferor’s assets to the entity
4. Transfer of a residence to the entity, with continued occupancy by the transferor

5. Tax-sensitive transfers defined by "audit-proofing" formulas

6. Insubstantial interests in the entity held by other persons

7. A token interest in the entity given to charity

8. A pattern of administering the entity as a trust, such as responding to the needs of the partner as a trustee would respond to the needs of a trust beneficiary

9. An entity that arguably has no cash needs of its own and therefore lends itself to this pattern, including an entity holding only passive investments such as stocks and bonds

10. Terms in a partnership agreement or other operating document that foster such a pattern, including (but not limited to) negation or limitation of a general partner's or manager's ordinary fiduciary duties

11. Absence of an interposed independent trustee holding entity interests

12. Commingling of personal and entity funds or payment of personal expenses by the entity

13. Other conduct that disregards the structure or purpose of the entity

14. Accomplishing no change or only a nominal change in the use and management of the assets transferred to the entity

See http://www.aicpa.org/members/div/tax/flapap.htm for the AICPA's white paper on FLP valuation discounts which provides an excellent discussion and analysis of the issues involved.

D. Thoughts on valuation discounts and underlying partnership assets

1. One school of thought states that the valuation discount depends entirely upon the terms of the partnership agreement and it is irrelevant whether the underlying asset is cash, marketable securities, real estate or any other asset-type. According to this school, the marketability and minority interest discounts are unaffected by the partnership's assets, since it is the limited partnership interest itself that is being valued. Instead, the valuation discounts hinge on the rights and obligations bestowed upon the limited partner by the partnership agreement.
2. Another school of thought, and the one to which this author subscribes, states that valuation discounts depend not just upon the rights (or lack thereof) of the limited partner, but also on many other factors including, among other things, the current economic environment, distribution history and expectations, holding period expectations, interest rates, partnership leverage and - yes - the nature of the underlying partnership assets and their expected returns. See Exhibit E for a listing of factors which affect FLP discounts.

3. Assume you are to value a 10% limited partnership interest in Partnership ABC which holds a non-income producing tract of raw land with a current market value of $1 million; the land has an appreciation expectation of 1% to 3% per annum, the partnership has an expected life of 15 years and investors in real estate companies with equivalent risk profiles demand a 10% rate of return. The present value of the year 15 value of $1 million growing at 3% per annum and using a discount rate of 10% is $0.37 million or a discount of 63%.

4. Assume instead that you are to value a 10% limited partnership interest in Partnership XYZ which holds a diversified stock portfolio with a current market value of $1 million, the portfolio has an appreciation expectation of 9% to 12% per annum, the partnership has an expected life of 15 years and investors in investment companies with equivalent risk profiles demand a 14% rate of return. The present value of the year 15 value of $1 million growing at 12% per annum and using a discount rate of 14% is $0.77 million or a discount of 23%.

E. State Law

1. The size of any lack of control and lack of marketability discounts applicable to an FLP is determined largely by the terms of the partnership agreement and state law. A common mistake of many appraisers is the failure to consider the impact of the agreement and applicable state law on a partner’s ability to realize the economic value of his interest. It is simply inappropriate to apply "standard" discounts in all FLP valuation engagements; every situation is unique.
Lack of Marketability Discount

Shares in closely held corporations do not enjoy the liquidity of shares actively traded on stock exchanges or in the over-the-counter market. The inability of an owner to quickly convert his shares into cash is a factor which affects value. It is widely recognized that owners of shares in closely held businesses do not enjoy the same liquidity experienced by shareholders of actively traded corporations. Empirical studies on this subject have been conducted by the Securities and Exchange Commission, Gelman, Moroney, Baird & Co., Willamette Management Associates and various others. These studies generally support discounts of 20% to 50% for lack of marketability. Listed below is a summary of major studies on restricted stock:

<table>
<thead>
<tr>
<th>Study</th>
<th>Years Covered</th>
<th>Average Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC (overall average)¹</td>
<td>1966-69</td>
<td>25.8%</td>
</tr>
<tr>
<td>SEC Study (American Exchange)¹</td>
<td>1966-69</td>
<td>25.5</td>
</tr>
<tr>
<td>Gelman²</td>
<td>1968-70</td>
<td>33.0</td>
</tr>
<tr>
<td>Trout³</td>
<td>1968-72</td>
<td>33.5</td>
</tr>
<tr>
<td>Moroney⁴</td>
<td></td>
<td>35.6</td>
</tr>
<tr>
<td>Maher⁵</td>
<td>1969-73</td>
<td>35.4</td>
</tr>
<tr>
<td>Standard Research Consultants⁶</td>
<td>1978-82</td>
<td>45.0</td>
</tr>
<tr>
<td>Willamette Management Associates⁷</td>
<td>1981-84</td>
<td>31.2</td>
</tr>
<tr>
<td>William L. Silber⁸</td>
<td>1981-88</td>
<td>33.8</td>
</tr>
<tr>
<td>Management Planning⁹</td>
<td>1980-96</td>
<td>27.1</td>
</tr>
<tr>
<td>FMV Opinions, Inc.¹⁰</td>
<td>1979-92</td>
<td>23.0</td>
</tr>
</tbody>
</table>

Source: Pratt, Reilly and Schweih, "Valuing a Business," fourth edition, p. 404. Cites for each individual study are presented below:


⁴From Robert E. Moroney, "Most Courts Overvalue Closely Held Stocks," Taxes, March 1973

⁵From J. Michael Maher, "Discounts for Lack of Marketability for Closely Held Business Interests," Taxes, September 1976
The studies on restricted stock transfers shown above include data on hundreds of transactions from 1969 through 1997. In these studies, there were various reasons the stock at hand was not freely marketable. However, in all cases the expectation was that the buyer would be able to resell the stock in the public market. The ultimate path to liquidity may have been via demand registration rights, piggyback registration rights, or Rule 144. In any case, the restricted shares were expected to become freely marketable in the foreseeable future. The results of these surveys are quite clear, investors demand to be compensated for the impact of illiquidity on their stock. Furthermore, the size of the compensation (in the form of a discount) in these studies has been found to be remarkably consistent, generally in the range of 20% to 50%.

Another method for measuring the discount that investors demand for illiquidity involves the study of private placement transactions occurring within a relatively short time period before a public offering. John D. Emery of Robert W. Baird & Co., an investment banking firm, conducted eight studies from 1980 through 1997 on private placements of stock occurring within months of a public offering. The mean and median discounts for all eight studies were 50% and 51%, respectively. In all cases, the public offerings were completed within five months after the private placement took place.

Willamette Management Associates has also performed eight studies similar to the ones performed by Robert W. Baird & Co. However, in the Willamette study, private transactions occurring within 36 months of the public offering were considered and overall changes in industry stock prices were taken into account in arriving at the median discount. The median discount for the eight Willamette studies ranged from 39% to 80%, with an average discount of approximately 62%. These studies further confirm the substantial discount demanded by investors for the impact of illiquidity.

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6From "Revenue Ruling 77-287 Revisited," SRC Quarterly Reports, Spring 1983
9As reported in Shannon Pratt’s Business Valuation Update Online, January 29, 1999
Lack of Control (minority interest) discounts

The degree of control, or lack thereof inherent in minority interest values, is an important variable that affects shareholder value. With regard to a minority interest, the courts have long recognized that "Minority stock interests in a closed corporation are usually worth much less than the proportionate share of the assets to which they attach." [Cravens v. Welch, 10 Fed. Supp. 94 (1935)]. Minority interest discounts exist because minority owners lack control over the underlying assets of the enterprise. Specifically, owners of minority interests generally lack the ability to control or direct certain actions, such as the ability to elect a majority or any directors, appoint management, or direct a sale, merger, liquidation or the payment of dividend distributions. Accordingly, the minority shareholder is often unable to realize many of the benefits associated with the underlying assets of a business.

Control Premium Studies

This lack of control causes the minority interest being valued to be worth less than its pro-rata share of the entire company. A minority interest discount is the mirror image of a majority interest or control premium. Accordingly, the size of a minority interest discount can be estimated by observing the premiums paid by acquirers when making acquisitions of controlling interests. Based on studies by Mergerstat Review of acquisition transactions that occurred between 1987 and 2002, premiums paid for corporate control as observed by premiums paid for controlling interests of publicly traded corporations have averaged approximately 40%. The inverse of the control premium is the minority discount. Therefore, the average implied discount for minority shares is approximately 30% based on the average control premium (calculated as 1 less the quotient of the pre-offer price divided by the offer price). It should be noted, however, that these premiums are based on a company’s stock price shortly before the date the merger transaction was announced. Because stock prices often rise shortly before such transactions are announced, the premiums may be understated.

Simpson Control Hierarchy

The minority interest discount is more accurately called a lack of control discount. Control should be viewed as a continuum from extremely limited for very small minority interests to almost absolute for very large majority interests. The Simpson Control Hierarchy, which is set forth below, is a model for analyzing the
levels of control available to stockholders. The hypothetical discount ranges shown below are not those of Simpson, but are merely hypothetical ranges added for illustrative purposes; each unique minority interest must be evaluated on its own. When valuing an ownership interest in a business, the characteristics of a particular ownership interest can be compared to those in the chart to assist the valuation analyst in estimating an appropriate lack of control discount.

<table>
<thead>
<tr>
<th>Level</th>
<th>Percentage Owned</th>
<th>Hypothetical Discount</th>
<th>Control Rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100%</td>
<td>None</td>
<td>Absolute</td>
</tr>
<tr>
<td>2</td>
<td>&gt;50%</td>
<td>0 – 5%</td>
<td>Able to force liquidation, merger, etc.</td>
</tr>
<tr>
<td>3</td>
<td>&gt;50%</td>
<td>0 – 10%</td>
<td>Unable to force liquidation, able to control full board of directors</td>
</tr>
<tr>
<td>4</td>
<td>&gt;50%</td>
<td>5 – 10%</td>
<td>Unable to force liquidation, unable to control full board, remaining ownership fragmented</td>
</tr>
<tr>
<td>5</td>
<td>&gt;50%</td>
<td>10 – 15%</td>
<td>Unable to force liquidation, unable to control full board, remaining ownership concentrated</td>
</tr>
<tr>
<td>6</td>
<td>&lt;50%</td>
<td>10 – 20%</td>
<td>Able to block major actions, able to obtain board seat, remaining ownership is fragmented</td>
</tr>
<tr>
<td>7</td>
<td>&lt;50%</td>
<td>10 – 20%</td>
<td>Able to block major actions, able to obtain board seat, remaining ownership is concentrated</td>
</tr>
<tr>
<td>8</td>
<td>&lt;50%</td>
<td>15 – 20%</td>
<td>Able to block major actions, unable to obtain board seat, remaining ownership is fragmented</td>
</tr>
<tr>
<td>9</td>
<td>&lt;50%</td>
<td>15 – 25%</td>
<td>Able to block major actions, unable to obtain board seat, remaining ownership is concentrated</td>
</tr>
<tr>
<td>10</td>
<td>&lt;50%</td>
<td>20 – 30%</td>
<td>Unable to block major actions, able to obtain board seat, remaining ownership is fragmented</td>
</tr>
<tr>
<td>11</td>
<td>&lt;50%</td>
<td>20 – 30%</td>
<td>Unable to block major actions, able to obtain board seat, remaining ownership is concentrated</td>
</tr>
<tr>
<td>12</td>
<td>&lt;50%</td>
<td>25 – 35%</td>
<td>Unable to block major actions, unable to obtain board seat, remaining ownership is fragmented</td>
</tr>
<tr>
<td>13</td>
<td>&lt;50%</td>
<td>25 – 40%</td>
<td>Unable to block major actions, unable to obtain board seat, remaining ownership is concentrated</td>
</tr>
</tbody>
</table>


**Partnership Studies**

Another manner in which to view minority interest discounts is by reference to the trading prices of limited partnership interests in publicly traded partnerships. During the 1980's, real estate limited partnerships were extremely popular with investors and billions of dollars worth of limited partnership units ("Units") were purchased by investors. The Tax Reform Act of 1986 severely limited the tax benefits associated with real estate limited partnerships and their popularity decreased. However, due to the massive distribution of these securities among investors, a secondary market emerged in the late 1980's and early 1990's for those investors wishing to sell their Units.
The secondary market is primarily made up of: (i) secondary market firms, which generally match buyers and sellers, and are motivated by commissions; (ii) individual buyers and sellers, who are motivated by yield, familiarity with the general partner and partnership, long-term values and real estate as an investment; and (iii) institutional funds, which are motivated by many of the same factors as individuals. However, unlike securities traded on the New York and American Stock Exchanges and Nasdaq, there is no central quote service for limited partnership units. Instead, it may take from several days to several weeks to receive some pricing indication, and this may be merely a general indication and not a firm bid. Finally, an actual sale may require several months to complete, due to the many rules applied by general partners related to transfers of limited partnership units.

Kam, Schroeder and Smith

Several empirical studies have been conducted on real estate limited partnerships in an attempt to quantify the discounts from net asset value ("NAV") at which their Units trade and to identify those factors that account for the discounts. Kam, Schroeder and Smith of Houlihan Valuation Advisors have conducted several such studies. Their first study examined the prices of 146 different limited partnerships in April and May of 1993. They found that the average limited partnership's Units traded at a 38% discount to its NAV. More specifically, they found that the average commercial real estate limited partnership's Units traded at a 57% discount to NAV. Their study also found that a key determinant of the size of the discount was the current yield of the Units. Discounts from NAV tended to be greatest for those partnerships where distributions were low or did not exist.

In 1994, Kam, Schroeder and Smith conducted a second and third study on the secondary markets for limited partnerships. The second study reviewed 109 limited partnerships that traded in the secondary markets in the first half of 1994. The third study looked at 168 limited partnerships that traded during the second half of 1994. The second and third studies revealed average discounts from NAV for distributing commercial real estate limited partnerships of 51.6% and 43.9%, respectively. A distributing partnership is one making annual distributions and it should be noted that the above discounts were found despite the median yield being greater than 9% in each study. For all partnerships reviewed, these studies found a high correlation between the size of the discount and the current yield as shown below.

<table>
<thead>
<tr>
<th>Current Yield Less Than</th>
<th>Discount from Net Asset Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Second Study</td>
</tr>
<tr>
<td>20%</td>
<td>44.1%</td>
</tr>
<tr>
<td>15%</td>
<td>43.7%</td>
</tr>
<tr>
<td>10%</td>
<td>48.5%</td>
</tr>
<tr>
<td>5%</td>
<td>73.6%</td>
</tr>
<tr>
<td>0%</td>
<td>75.4%</td>
</tr>
</tbody>
</table>
These findings are consistent with financial theory. Where a partnership is distributing all of its current earnings, one would expect lower discounts for lack of control since the limited partners are receiving their share of the partnership's income on a current basis. On the other hand, where a partnership is either accumulating its current income or has none, one would expect investors to demand large discounts from NAV to be induced to purchase their Units. The size of the discounts demanded should reflect the uncertainty associated with the timing of any future operating or liquidating distributions.

Kam, Schroeder and Smith concluded that the most important factors that influence the pricing of limited partnership interests are current distributions, net asset value, cash flow (in the form of operating surplus) and book value. They also pointed out that private partnerships often do not enjoy professional management, property diversification, mandatory distribution requirements or a secondary market of any kind. Thus, they suggest that discounts from NAV for Units of a private partnership are likely to be larger than for Units of a publicly traded partnership.

The Partnership Spectrum

The Partnership Spectrum (Spencer Jeffries, ed.) has also conducted studies of the discounts applied to the NAV of publicly traded partnerships based on actual partnership trades. The studies are conducted annually and include only partnerships that have not announced any liquidation plans. The NAVs used in the studies are at or near each calendar year end and the trading prices are from trades occurring in April and May of the following year. The NAVs used assume the sale of all properties at their estimated market values, the payment of all related expenses and the liquidation of the partnership. We note that the discounts identified in The Partnership Spectrum studies are the discounts from NAV paid by the buyer. Sellers generally must also pay commissions and transaction costs ranging from 5% to 10% of the transaction amount. As a result, these discounts are understated.

The Partnership Spectrum noted that the overall discounts from NAV for publicly traded real estate partnership interests have declined during the last several years and attributed the decline to the fact that secondary market buyers have been factoring ever shorter anticipated holding periods into their pricing models. In fact, many secondary market buyers are now expecting that most of these partnerships will be liquidated in the next three to five years, even though no liquidation plans have been announced. While secondary market buyers certainly factor current distribution yields into their pricing models, the potential for reaping near-term capital gains from partnership liquidations is even more appealing than quarterly distributions. However, The Partnership Spectrum further noted that for those partnerships that have not announced definitive liquidation plans, investors focus on whether the partnership has the ability to pay operating distributions and the level of debt financing utilized by the partnership. The less able the partnership is to pay
operating distributions and the higher the level of debt financing, the higher the discount applied to the partnership's NAV. *The Partnership Spectrum* also noted that investors ascribe little value to the equity build-up within partnerships due to debt reduction.

The 1999 study, which was based on year-end 1998 NAV data and trading prices in April and May 1999, yielded the following results:

<table>
<thead>
<tr>
<th>Type of Partnership</th>
<th>Number of Partnerships</th>
<th>Average Discount</th>
<th>Average Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - paying distributions, with low or no debt</td>
<td>27</td>
<td>25%</td>
<td>8.8%</td>
</tr>
<tr>
<td>Equity - paying distributions, with moderate to high debt</td>
<td>17</td>
<td>35%</td>
<td>6.9%</td>
</tr>
<tr>
<td>Equity - not paying distributions</td>
<td>15</td>
<td>46%</td>
<td>0%</td>
</tr>
<tr>
<td>Undeveloped land</td>
<td>4</td>
<td>46%</td>
<td>0%</td>
</tr>
</tbody>
</table>

The 2002 study, using year-end 2001 NAV data and trading prices in April and May 2002, showed that discounts had declined since 1999 for the reasons noted above. The results of the 2002 study are shown below:

<table>
<thead>
<tr>
<th>Type of Partnership</th>
<th>Number of Partnerships</th>
<th>Average Discount</th>
<th>Average Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - paying distributions, with low or no debt</td>
<td>18</td>
<td>16%</td>
<td>8.6%</td>
</tr>
<tr>
<td>Equity - paying distributions, with moderate to high debt</td>
<td>14</td>
<td>26%</td>
<td>6.5%</td>
</tr>
<tr>
<td>Equity - not paying distributions</td>
<td>5</td>
<td>32%</td>
<td>0%</td>
</tr>
<tr>
<td>Undeveloped land</td>
<td>3</td>
<td>35%</td>
<td>0%</td>
</tr>
</tbody>
</table>

It should be noted that the aforementioned partnership studies dealt with partnership interests that were traded on a secondary market. Accordingly, some analysts believe that the discounts found in these studies were attributable solely to the lack
of control inherent in limited partnership interests. However, most practitioners believe that discounts from NAV found in these partnership studies include at least some discount related to liquidity due to the relative inefficiency of the secondary market for public partnership interests and the time required to complete trades. Accordingly, the discounts found in these partnership studies may slightly overstate the size of the discount for lack of control.

We note that discounts for private limited partnerships and limited liability companies are generally much larger than discounts for publicly traded limited partnerships. Investors in private limited partnerships and limited liability companies demand higher returns on their investments than investors in publicly traded limited partnerships due to various factors, including the lack of: (i) professional management; (ii) asset diversification; (iii) mandatory distribution requirements; (iv) a secondary market; and/or (v) SEC registration and public oversight.

Closed-End Investment Companies

Closed-end investment companies are often used as a proxy to estimate the minority interest discount applicable to a private or family-owned investment company. A closed-end investment company is a publicly traded investment company. It raises funds from the public and uses the funds to invest in securities. Domestic closed-end investment companies generally trade on the New York or American Stock Exchange. Because closed-end investment companies have a fixed number of shares outstanding, the price at which its shares trade may be at a premium or discount to their underlying NAV.

Most closed-end investment companies trade at discounts to their NAV. The discount is generally thought to be a function of one or more of the following factors: (i) built-in taxes related to appreciated securities in the fund; (ii) the annual fees and expenses charged by the manager of the fund; and/or (iii) the lack of control discount associated with the inability of a minority shareholder to cause the fund to be liquidated, alter its investment strategy or otherwise control management of the fund. Shareholders of closely held investment companies are also subject to these discount-generating factors, and often to a much greater degree.

Because closed-end investment companies are traded actively on established exchanges, none of the discount to NAV at which they trade is related to lack of marketability. Furthermore, because closed-end investment companies are highly regulated, the lack of control discount for a closed-end investment company is expected to be substantially lower than the discount for a similar family-owned investment company. Clearly, the minority shareholder's lack of control should be less important to the shareholder of a regulated and publicly traded investment company than to the shareholder of a non-regulated private investment company.
I. **CASE HISTORY.** The initial Tax Court decision held that the partnership would be respected for tax purposes despite non-tax motives for its creation, rejected any "gift on creation" for gift tax purposes, held that sections 2073 and 2704 did not apply, and determined the amount of discounts. 115 T.C. 478. The initial decision refused to allow the IRS to pursue a claim under section 2036 on procedural grounds. The Fifth Circuit Court of Appeals agreed with the Tax Court’s rulings on the substantive issues but reversed on the procedural issue, and remanded the case for the Tax Court to consider the section 2036 claims by the IRS. 293 F.3d 279 (5th Cir. 2002). This is the consideration of the Section 2036 issue on remand by the Tax Court. This is a memo decision by Judge Cohen, and is not a decision reviewed by the full Tax Court.

II. **FACTS EMPHASIZED BY COURT**

A. 98% of decedent’s wealth was contributed to partnership and corporation.

B. 99% limited partnership interest was retained by decedent.

C. 1% general partner was new corporation owned 47% by decedent and 53% by decedent’s children. (Children subsequently gave 1% to a Foundation.)

D. Corporation entered management agreement with decedent’s son-in-law (who was also decedent’s attorney-in-fact under a power of attorney) to manage day-to-day business of the corporation and partnership—which the court interpreted to include making all distribution decisions.

E. Partnership agreement provided that income, after deducting certain listed expenses “shall be distributed at such times and in such amounts as the Managing General Partner, in its sole discretion, shall determine, taking into account the reasonable business needs of the Partnership (including plan for expansion of the Partnership’s business)."
F. Various distributions were made to or for decedent or decedent’s estate (including home health care, medical expenses of health care provider, funeral expenses, estate administration expenses, debts of decedent, specific bequest, and estate and inheritance taxes).

III. HOLDINGS

A. Section 2036(a)(1). Section 2036(a)(1) applies to the corporation and partnership created by decedent.

1. Circumstances that generally suggest an implicit retained interest under §2036(a)(1) include: “transfer of the majority of the decedent’s assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement.”

2. Formalities recognizing the entity were followed (“the proverbial ‘i’s were dotted’ and ‘t’s were crossed’.”)

3. Facts in this case indicating implicit retention of economic benefit:

   a. Decedent contributed 98% of his wealth, including his residence. The fact that decedent possessed “liquefiable” assets to cover decedent’s anticipated living needs over his short life expectancy did not matter. The relative dearth of liquefied as opposed to “liquefiable” assets reflect that the partnership and corporation would be the primary source of decedent’s liquidity.

   b. The decedent continued physical possession of his residence. The partnership charged rent to the decedent, but the court observed that the fact that the rent was merely accrued and not actually paid until over 2 years after decedent’s death reflects that the rent was not arm’s length. The court concluded that “accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment.”

   c. While pro rata distributions were made to all partners, because interests held by others are de minimis, “a pro rata payment is hardly more than a token in nature.”

   d. Actual distributions reflect “a conclusion that those involved understood that the decedent’s assets would be made available as needs materialized.”
e. The partnership/corporation arrangement has more testamentary characteristics than a joint investment vehicle for management of assets. Factors supporting this conclusion include the unilateral nature of the formation, the fact that contributed property included the majority of decedent’s assets, and the decedent’s advanced age and serious health condition.

f. “[T]he crucial characteristic is that virtually nothing beyond formal title changed in decedent’s relationship to his assets.” The children did not have a meaningful economic stake in the property during decedent’s life and made no objections or concerns when large sums were advanced to decedent or his estate.

B. **Section 2036(a)(2).** Section 2036(a)(2) applies to transfers to the corporation and partnership.

1. **Factors Causing 2036(a)(2) Inclusion.** The court analyzed in detail the facts of this case compared to the Byrum case.

a. **Problematic Retained Powers.** Decedent retained legally enforceable rights to designate who shall enjoy property and income from the partnership and corporation. The court emphasized that it is immaterial whether the documents and relationships create rights exercisable by decedent alone or in conjunction with other corporate shareholders and the corporation’s president.

i. Partnership income—the agreement gave the general partner “sole discretion to determine distributions.”

ii. Partnership property—decedent can act together with the other shareholders to dissolve the partnership. (Under the partnership agreement, the partnership is dissolved by unanimous vote of limited partners and general partner. Under the corporation’s bylaws, all of the corporation’s shareholders must consent to dissolution of the partnership. Thus, decedent could act in his capacity as a limited partner and shareholder with the other owners to dissolve the partnership.)

iii. Corporation property and income—decedent “held the right, in conjunction with one or more other Stranco directors, to declare dividends.”

iv. “Banding together” is sufficient. Taxpayers argued that if the mere fact that a decedent “could
band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under section 2036(a)(2), the Supreme Court could not have reached its decision in Byrum. The court responded with an analysis of the additional constraints in Byrum that are not present in this case.

2. **Comparison to Byrum.** Additional constraints upon rights to designate in Byrum that are not present in this case:

   a. **Independent Trustee.** In Byrum, the decedent retained the right to vote stock, which could be used to elect directors, who decided what distributions would be made from the corporation. However, the stock was given to a trust with an independent trustee who had the sole authority to pay or withhold income. In this case, distribution decisions were made by the corporation. The decedent owned 47% of the stock and was the largest shareholder. All decisions were ultimately made by decedent's attorney-in-fact as the manager of the corporation and partnership. (OBSERVATION: In Byrum, a 2-step process was required to make distributions. First, the corporation had to distribute cash to the trust (and this decision was, under the court’s analysis, made in connection with the decedent). Second, the independent trustee could decide to make distributions to beneficiaries. What if a partnership agreement provided a 2-step process to make distributions and the decedent could not participate at all in one of those 2 steps? If that would cause a different result, is it really important that there was a second step in Byrum that could only be exercised by an independent trustee?) (Would there have been a different result if the limited partnership interests had been given to a trust with an independent trustee who made distribution decisions?)

   b. **Economic and Business Realities.** The flow of funds in Byrum was dependent on economic and business realities of small operating enterprises which impact the earnings and dividends. “These complexities do not apply to [the partnership or corporation], which held only monetary or investment assets.”

   c. **Fiduciary Duties.** Fiduciary duties in Byrum were distinguished because there were unrelated minority shareholders who could enforce these duties by suit.
"The rights to designate traceable to decedent through [the corporation] cannot be characterized as limited in any meaningful way by duties owed essentially to himself. Nor do the obligations of [the corporation's] directors to the corporation itself warrant any different conclusion. Decedent held 47 percent of [the corporation], and his own children held 52 of the remaining 53%. Intrafamily fiduciary duties within an investment vehicle simply are not equivalent in nature to the obligations created by the United States v. Byrum, supra, scenario." The fact that there was a 1% shareholder of the corporation was "no more than window dressing." "A charity given a gratuitous 1-percent interest would not realistically exercise any meaningful oversight." (OBSERVATION: The IRS made the argument that fiduciary duties negate the application of section 2036 only if there are unrelated parties to enforce the duties in Letter Ruling 8038014. Holding that fiduciary duties provide a limit on the right to designate who enjoys or possesses transferred property only if there are unrelated persons who can enforce those duties seems inconsistent with many cases that have held that very broad administrative powers retained by a donor as trustee do not invoke section 2036, primarily because of the restriction imposed by the fiduciary duties. Those cases involve trust transactions that do not involve any unrelated parties. E.g. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970)(broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review).)

C. Bona Fide Consideration Exception. The bona fide consideration exception under Section 2036 does not apply.

1. Strangi and two previous Tax Court memorandum decisions (as well as a decision of the federal district court of North Texas) have interpreted this exception in a partnership context as having two requirements. (See Estate of Thompson v. Commissioner, T.C. Memo. 2002-246; Estate of Harper v. Commissioner, T.C. Memo. 2002-121; Kimbell v. U.S., 244 F. Supp. 2d 700 (N.D. Tex. 2003.) The court stated that this exception under section 2036 has two requirements: (1) A
bona fide sale, meaning an arm's length transaction, and (2) adequate and full consideration.

a. No bona fide arm's length transaction occurred. The decedent's attorney-in-fact prepared all documents without any meaningful negotiation or bargaining with other interest-holders.

b. Full and adequate consideration does not exist where there is a mere "recycling" of value through partnership or corporate solution. "Without any change whatsoever in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise, there exists nothing but a circuitous 'recycling' of value." Decedent contributed more than 99% of the total property and received back an interest "the value of which derived almost exclusively from the assets he had just assigned." (OBSERVATION: This analysis suggests the wisdom of having parties other than the decedent contribute substantial assets to the partnership.) The court distinguished the Church case, which was affirmed by the 5th Circuit Court of Appeals (which will hear the appeal of this case), because Church involved "contributions by other participants not de minimis in nature."

D. Effect of Applying Section 2036. The effect of applying section 2036 in the context of creation of the corporation and partnership is that 99% of the asset value of the partnership and 47% of the asset value of the corporation are included in decedent's estate. (These percentages are the same as decedent's ownership of the entities.) In effect, the existence of the partnership and corporation was ignored for estate tax purposes.

IV. PLANNING IMPLICATIONS

A. Memo Decision. This is a memorandum decision, rather than a decision of the full Tax Court. That's interesting because the analysis under section 2036(a)(2) is novel and potentially far-reaching. However, it has not been reviewed by the full Tax Court.

B. Appeal to 5th Circuit. The IRS obtained all relief that it had been seeking in its notice of deficiency. There seems little doubt that the estate will appeal this decision to the 5th Circuit Court of Appeals. The 5th Circuit previously rejected a section 2036(a)(1) and 2036(a)(2) claim by the IRS on a partnership with a less than perfect

C. Section 2036(a)(1) Issues.

1. Formalities Not Enough. Observing formalities was not sufficient to avoid section 2036(a)(1). (Many of the prior section 2036(a)(1) cases involved the failure to observe corporate and partnership formalities. E.g., Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242.)

2. Retain Assets for Living Expenses. Retain sufficient liquid (not just "liquefiable") assets outside the partnership to provide anticipated living expenses.

3. Residence. Do not transfer residence to partnership.

4. Rentals. If taxpayer uses partnership assets, pay fair market value rental in an arm's length manner. Actually pay rent and do not just accrue rentals.

5. Decisions Based on Personal Needs. The purpose of distributions should be based on business reasons of the partnership and not on personal desires of the taxpayer to cover personal cash needs.

6. Contributions by Others. Having significant contributions by others helps. Making pro rata distributions to multiple partners does not appear so much that taxpayer implicitly retained the ability to access partnership assets whenever desired. Avoiding a unilateral creation and seeking input from others about structural issues helps avoid a "testamentary" appearance.

D. Section 2036(a)(2) Issues.

1. Dictum? Is all of the discussion about section 2036(a)(2) technically dictum, because the holding for the IRS under section 2036(a)(1) gave the IRS all of the relief that it requested? In the words of the court, "We address these arguments as an alternative to our conclusions concerning section 2036(a)(1)."
2. **Sole Discretion Over Cash Distributions.** Perhaps critical to the court's analysis is that the partnership agreement gave the managing partner "sole discretion" over distributing income in excess of business needs rather than mandating distributions of all cash in excess of business needs. (Structuring the partnership agreement to mandate distribution of "excess cash" would help with respect to retained powers over income, but would not seem to help rebut an argument over the retained powers to liquidate and distribute the entire assets of the entity "in connection with" the other owners.)

3. **Narrow Interpretation of Byrum.** The court interpreted Byrum very narrowly. In particular, it rejects a "fiduciary duty" analysis that renders section 2036(a)(2) inapplicable if retained administrative powers that impact distributions are held in a fiduciary capacity. The court views Byrum as being limited by special constraints on the donor's retained rights in that case, including (i) an independent trustee ultimately made distribution decisions, (ii) cash flow from the small operating enterprise in Byrum was subject to economic and business realities that do not apply to an investment partnership, and (iii) there were unrelated parties in Byrum (beyond just a de minimis 1% interest) who give rise to a realistic possibility for enforcement of fiduciary duties. That interpretation is far more restrictive than the IRS's published position on Byrum in Rev. Rul. 81-15, 1981-1 C.B. 457. (Interestingly, the court cites the IRS's unpublished rulings interpreting Byrum with respect to partnerships [PLRs 9415007, 9310039, & TAM 9136006] and discounts those rulings as having no precedential force, but does not cite the IRS's published position interpreting the fiduciary duty analysis in Byrum.)

4. **"In Connection With" Broad Application.** The court, perhaps to a larger extent than any previous section 2036(a)(2) case, interpreted the "in connection with" language in the statute and regulations very broadly. The court's analysis, when pushed to its extreme, would mean that any family entity could be ignored under section 2036(a)(2) because the decedent—regardless how small of an interest that the decedent held—would hold the power, "in connection with others" to vote its interest as a member of the entity (i) to affect indirectly when income distributions would be made, and (ii) to liquidate the entity and distribute its assets. An extension of this analysis could ultimately lead to negating any fractionalization discounts where the other interests in an asset are held by family
members. (For example, the taxpayer could act "in connection with" other family owners to sell the asset, thus avoiding or minimizing any minority or marketability discounts. This is basically yields the result—under section 2036 rather than under a valuation approach—that the Treasury Department has pushed in several different legislative sessions, but that has, so far, been rejected by Congress.) It seems very doubtful that courts will extend the application of section 2036 in this manner to negate fractionalization discounts.

5. Planning Structure of General Partner. In light of the court's "in connection with" analysis, the most conservative structure to avoid section 2036(a)(2) would be for the taxpayer to own no interest in the general partner. (However, even that structure would not be immune from attack, under the court's reasoning, if the partnership can be liquidated with the consent of all partners; the decedent could then act "in connection with" other owners to liquidate the entity at any time and regain possession of his proportionate part of the assets in the entity.) Furthermore, if another individual serves as general partner, be wary of giving that individual a general power of attorney. The court gave little weight to fiduciary duties that the son-in-law held as manager of the partnership and corporation because he stood in a preexisting confidential relationship and owed fiduciary duties to decedent personally as his attorney in fact.

E. Consideration Exception to Section 2036.

1. Statutory Exception. Section 2036(a)(1) or (a)(2) only applies if the decedent has "made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth)."

2. Two-Step Analysis.
   a. The first requirement is that there is a bona fide sale, meaning an arm's length transaction. Having other partners (even family members) and having negotiations in the structure decisions would help meet this requirement.
   b. The second requirement is that there is "full and adequate consideration." The court holds that the receipt by the donor of limited partnership interests in return for the transfer of assets to the partnership is not "adequate and full consideration" even though the Tax Court has held on various occasions (including the initial
Stranigi decision) that the creation of the partnership does not result in a “gift on creation” for gift tax purposes. The court reasons that “full and adequate consideration” does not exist where there is merely a “recycling” of value through partnership or corporate solution. The court cited its explanation in Harper that there is a mere “recycling” where there is no change whatsoever “in the underlying pool of assets or prospect for profit, as, for example, where others make contributions of property or services in the interest of true joint ownership or enterprise.” Thus, having other partners who make contributions to the “underlying pool of assets” would help in arguing that the full consideration exception applies.
Exhibit E

Listing of Factors Impacting Lack Of Control And Marketability For FLPs

No single formula or approach will effectively estimate the discount from net asset value that appropriately reflects the impairment of value resulting from a minority interest’s lack of control and marketability. Each situation is unique and many factors must be considered prior to making final judgment. The chart below summarizes eleven key factors that we consider in determining discounts for lack of control and marketability for each FLP interest. This chart also summarizes the expected interaction between each factor and the size of the discount. For example, the valuation discount would tend to be lower for a minority owner that has strong withdrawal and distribution rights, as opposed to one that does not, because these rights provide such owner with enhanced elements of control and liquidity.

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<td>Recent performance</td>
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<td>Business risk (esp. diversification)</td>
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<tr>
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