Valuing Family Limited Partnerships

By Bryan Goetz and Pat Cooney

Family limited partnerships (FLPs) have become very popular estate planning tools in the last few years. A key determination in the use of a FLP is the value of the partnership interests. To make this determination, a business appraisal must be performed. The business appraisal will value the interest under the fair market value standard that is applicable to gift and estate tax transfers. The following shows the considerations in the valuation of a FLP.

The first item that must be considered in valuing an interest in a FLP is the partnership agreement. This will set forth the rights, duties and restrictions that affect value. The terms of the agreement can substantially affect the value of the subject interest, upward or downward, so it is important for the business appraiser to analyze the agreement carefully and assess each term's affect on value.

After analyzing the partnership agreement, the business appraiser will normally analyze the portfolio of assets in the partnership and calculate the partnership's overall asset value less liabilities, or net asset value. The portfolio should be analyzed comprehensively with respect to diversification, risk, growth and ability to produce future income.

Once the net asset value is calculated and analyzed, the business appraiser should evaluate the overall economic and industry environment that the partnership is affected by. Once this is done, the business appraiser will have the facts necessary to place a value on the subject interest.

The most common technique used in valuing an interest in a FLP is to start at net asset value and then apply a minority discount, and then apply a discount for lack of marketability.

A minority discount takes into consideration the fact that a typical limited partnership interest doesn't have the power to access the assets or income of the partnership. That power is normally in the hands of the general partners. The benchmark for determining the minority discount is control premiums that are paid to acquire public companies. For instance, *Mergerstat Review* data show that the average premium paid to acquire control of public companies has fairly consistently been about 40 percent. This control premium translates into an average minority discount of about 29 percent (.40/1.40).

The lack of marketability discount considers the fact that closely-held partnerships usually have a very limited market in which to sell interests. When an interest of a closely-held partnership is sold, it is usually at a price that is much less than that which could be obtained in the public marketplace. The benchmarks for the lack of marketability discount are studies relating actual sales prices of stock before initial public offerings to their prices after the public offerings. For instance, John D. Emory published a study of actual transactions before initial public offerings in the September 1997 issue of *Business Valuation Review* that determined a median discount of 61 percent for 22 actual transactions in the 1996/1997 study period.

Another important valuation approach is the capitalization of income. It is well known that income is an important consideration to investors. Partnerships that trade in the secondary market have levels of discounts from net asset value that are inversely related to the level of income that is paid out. Thus, the higher the distributions, the lower the discount from net asset value. Capitalization of income is the process in which the business appraiser assesses an estimated normalized income stream, and converts that income stream into value by consideration of the income's expected growth and level of risk, and the interest's control powers.

One approach that is sometimes used is the market approach, in which the subject partnership is compared to either publicly-traded partnerships or ones that are traded in the secondary market. However, it is usually very difficult to find partnerships that are sufficiently comparable to the subject FLP to make the comparison meaningful.

Once all of the relevant approaches to value are performed, the business appraiser weights the results in order to determine a final value. This value is often then cross-checked by discounts that are found in the secondary market for real estate partnerships. For example, The *Partnership Spectrum* recently published that the average secondary market discount from net asset value for real estate partnerships that were not making distributions was 42 percent, with a range of 25 percent to 62 percent.

In summary, FLPs can be valued by applying the aforementioned approaches. However, it should be noted that FLPs that have not been setup properly or appraised poorly, will likely be scrutinized by the IRS. In addition, President Clinton's budget proposal includes a provision that would eliminate the use of FLPs, though not retroactively. Despite this, the use of FLPs will likely remain a popular estate planning tool, especially considering the fact that most experts give President Clinton's budget little chance of passage.

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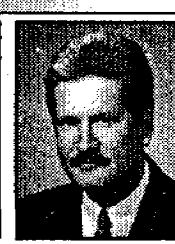

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