A FAMILY LIMITED PARTNERSHIP (FLP) VALUATION EXAMPLE
By: Linda B. Trugman, CPA/ABV, MCBA, ASA, MBA

Family Limited Partnerships (FLPs) have grown in popularity as an estate planning tool and a way to depress transfer tax values. Business valuation experts should be aware of the issues involved in valuing FLP interests and how to prepare a report that is less likely to be challenged by the Internal Revenue Service (IRS) or, if challenged, will more likely be resolved in favor of the taxpayer.

Valuation analysts need to do more than focus on what discounts they can use to reduce the value of a FLP interest. The FLP agreement and other partnership documents must be thoroughly analyzed before the valuation analyst can begin to render an opinion of value. The final report must at least contain certain information about the assignment - the nature of the interest being valued, the terms of the partnership agreement, and the financial condition of the entity.

This discussion is designed as an overview of the FLP valuation process and the items to consider. It is designed to help you prepare valuation reports more effectively and perhaps minimize the opportunity for the IRS to challenge your opinion of value. This discussion also assumes that the reader has a basic understanding about FLPs. Please note that FLP is being used as a generic term in this paper. Many attorneys are currently using Limited Liability Companies (LLC), rather than Limited Partnerships, but the overall structure of the transaction and the valuation issues are the same.

WHAT IS A FLP? A FLP is a nontaxable entity that is created and governed by statute and whose partners (both general and limited) and assignees consist mainly of family members.

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

PENALTIES: Valuation analysts should be warned that applying discounts too enthusiastically can backfire. Section 6701 of the IRC imposes civil penalties on valuation analysts of $1,000 for "aiding and abetting an understatement of tax liability." The IRS could also impose an administrative sanction barring the valuation analyst from submitting probative evidence in future IRS proceedings. For these reasons, the report must be prepared judiciously and every statement be carefully documented and presented in such a way that the valuation conclusion can be replicated and understood by those for whom it is intended.

The valuation analyst should also be aware of the new appraiser penalty rules that were described in the Pension Protection Act of 2006. Although these penalties specifically apply to valuations for charitable contribution purposes, many believe that they will ultimately be extended to appraisals of property for income and transfer tax purposes. The penalties fall into two categories, a "gross valuation misstatement" and a "substantial valuation misstatement." For more information about the Pension Protection Act and its affect on appraisers, see *Pension Protection Act Changes Valuations for Tax Purposes* (http://aicpa.org/pubs/jofa/sep2007/crain.htm).

STARTING THE ASSIGNMENT: The valuation analyst should obtain a retainer agreement (and a retainer) from the client which should spell out the precise nature of the assignment the analyst is going to perform. In order to prepare a thorough analysis and report, the valuation analyst needs the following information:

1. The name of the client, i.e., the person who engaged the valuation analyst. The client is responsible for identifying the nature of the interest to be appraised.
2. The nature of the interest being appraised, e.g., general partner interest, limited partner interest, limited liability company member interest, assignee interest. It is important to note that what is

being appraised is **not** a percentage interest in any or all of the assets owned by the FLP, but rather an *interest in the FLP itself*.

3. The size of the interest being valued. Size can be represented by a percentage interest amount, number of units or shares, or even dollar amount.
4. The valuation date, and the purpose for which the valuation is being performed, i.e., whether it is for estate planning (gifting) or estate valuation purposes.
5. The standard of value. The retainer agreement should provide a definition of the standard of value that will be determined in the appraisal. These are defined in the following tax regulations:

<u>Estate planning</u> (gifting) - Treasury Regulation 25.2512-1
<u>Estate valuation</u> (after death) - Treasury Regulation 20.2031-1(b)

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

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

WHAT DOCUMENTS ARE NEEDED?

a. The FLP Agreement (or other type of business agreement depending upon the form of the entity), as well as a copy of the Certificate of Formation that has been filed with the state where the entity has been created. If the valuation analyst is not familiar with the statutes of the state of formation (whether limited partnership or limited liability company), it should be obtained. Most of them are on line at the various Secretary of State's websites.
2. A list of the assets that were initially contributed to the partnership, as well as documentation of any assets that were contributed after the formation of the FLP.
3. Valuations of real estate and other assets held by the FLP as of the valuation date (for example, market values of marketable securities). If the FLP owns interests in other closely held businesses or partnerships, these interests must be separately appraised before the value of the LP interest can be determined.
4. Financial statements and/or tax returns for the partnership for a reasonable number of years, or since inception. If it is a new partnership, these will not exist.
5. The general partner's anticipated policies regarding distributions or a Section 754 election.
6. If the FLP is ongoing, a history of distributions, if any, made to partners.

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

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

This Chapter consists of only four sections; three of which actually relate to family limited partnerships. If the partnership does not comply with the provisions of this Chapter, the IRS may determine that the partnership does not exist for tax purposes and value the underlying assets directly in calculating the applicable gift or estate tax. The provisions of the Agreement should comply with the sections of Chapter 14; however, it is up to the attorney to make sure that the Agreement is legally binding, not the valuation analyst's.

THINGS TO CONSIDER IN THE APPRAISAL PROCESS: The basic characteristics of the transferred interest in the FLP, combined with specific provisions in the FLP agreement and under state law, form the foundation for the valuation adjustments used in arriving at the fair market value of the transferred interest in the FLP. Some of the factors to be considered in determining appropriate valuation adjustments are:

Provisions in the Partnership Agreement

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

Factors Not Found in the Partnership Agreement

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

WHAT ABOUT METHODOLOGY? What is the best approach to use to value a FLP interest? Which methods can and should be used? Section 5 of Revenue Ruling 59-60 states in part:

> (a) ... in general, the valuation analyst will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public, conversely, in the investment or holding type of company, the valuation analyst may accord the greatest weight to the assets underlying the security to be valued.

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

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

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

In deciding on the methodology to apply to the valuation of partnership interests,

> When valuation consultants use an asset based approach to value a FLP interest, the restrictions in the partnership agreement are often the sole justification for the amount of the discounts. In these cases, the IRS attempts to disregard the restrictions for valuation purposes by demonstrating that the terms of the partnership agreement are onerous and not comparable to arm's-length transactions. If the restrictions are disregarded, the IRS then argues to invalidate the partnership agreement for valuation purposes, resulting in a significant increase in the value of the limited partnership interest.
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> While this rationale has not been proven in tax court, the IRS has used it to successfully negotiate with taxpayers for an increase in the amount of gift and estate taxes that would have otherwise been paid. If the valuation is determined using the income and market approaches and does not rely solely on the restrictions in the partnership agreement, it is more difficult for the IRS to dispute the valuation.[1]

Asset Based Approach: Obtain fair market value of all assets and liabilities on the balance sheet and apply appropriate discounts (for lack of control and marketability).

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1 Jay E. Fishman, et.al., *Guide to Business Valuations*, 10th edition (2000: Practitioners Publishing Company, Texas), p. 14-11.

Income Approach: Determine cash flow available to partners, and capitalize or discount as appropriate.[2] Apply discount for lack of marketability (no discount for lack of control necessary as cash flow capitalized or discounted is the amount available to the minority owner, and therefore, the result is a minority value).

Because of what Section 5 of Revenue Ruling 59-60 says, many analysts do not think that an income approach is appropriate when valuing an interest in a FLP. However, a minority owner cannot force the sale of the underlying assets of a business, and although the valuation analyst applies a discount for lack of control to account for this (among other factors), does the discount truly account for the inability of the minority owner to obtain the value of the underlying assets? Valuation theory discusses this issue and textbooks state that the asset based approach is generally inappropriate when valuing a minority interest unless the holder has the right to liquidate the entity or sell off the assets and distribute the proceeds.

There is generally no plan to sell the assets before an FLP before termination, which is generally at least 20 to 30 years from the date of inception. Therefore, it seems that if an FLP generates income, this reflects and actual return to the minority owner, and should be considered in the valuation process. However, if the FLP is not distributing the income, the minority owner may be faced with a similar situation as under an asset based approach – there is income, but the minority owner does not receive the benefit of it.

Another issue in applying an income approach is the amount of income earned. Very often, the investment earnings or net rental income is very low, but the growth in the assets is large. Unless there is a plan to sell the assets at a definitive time in the future, the return to the minority owner is a low level of income that does not truly reflect the value of the assets. However, the appraiser should still remember that the minority owner cannot force the sale of the assets, and therefore, the assets do not have as much value to a minority owner.

Another potential problem that exists is the selection of a discount or capitalization rate, especially if the holdings are marketable securities. Although market-derived rates of return are available, they are usually derived from ownership of the underlying assets However, the valuation assignment is to value an interest in a holding company, and therefore, adjustments must be made to the market-derived rates to adjust for risk.

Market Approach: Determine valuation multiples by looking for comparable publicly traded interests, The appropriate multiple could be price to NAV (net asset value), adjusted for the risks associated with your specific valuation assignment.[3] From a practical standpoint, this is generally the same as the asset-based approach.

VALUATION ADJUSTMENTS: Valuation adjustments are supposed to reflect the lack of control inherent in limited partnership interests and the lack of marketability any type of closely-held partnership interest endures. These are two separate issues that usually result in two separate adjustments or discounts. The Courts recognize the necessity for these discounts, but often disagree with how much of a discount may be allowed.

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

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

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[2] Sources of rates of return include *The Wall Street Journal*, Ibbotson Associates, National Association of Real Estate Investment Trusts (NAREIT).

[3] Sources for comparable (guideline) data are Closed End Mutual Funds (*The Wall Street Journal*, Morningstar) and *Partnership Spectrum* published by Partnership Profiles, Inc.).

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

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

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

Discount for Lack of Control: The types of assets owned by the partnership must be considered when finding a starting point for this discount.[4] Although a FLP could hold almost any type of asset, most FLPs own either marketable securities, real estate, or some combination of both.

Marketable securities: A logical reference point when valuing such a FLP is a closed-end investment company. It is best to use closed-end investment companies (mutual funds) that hold publicly traded securities that are similar to the securities held by the FLP, such as domestic stocks, foreign stocks, speciality funds, corporate bonds, municipal bonds, or government bonds. There are many other types of funds.

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

Whether the valuation analyst adjusts these discounts before applying them to his or her FLP interest is a question of specific facts and circumstances of your particular valuation. If you believe that the interest you are appraising has less control, then you might increase the discount, and vice versa. Another issue relates to the similarities of the portfolios. The valuation analyst might believe that his or her portfolio would trade at a higher or lower discount. Whatever position the valuation analyst takes, the discussion should include all the reasoning behind the adjustments.

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

There are several factors that might be considered in making adjustments to the starting point for the discount for lack of control. Remember that adjustments should be reasonable and reflect the facts of the particular FLP interests.

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

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4 The analyst might not need a discount for lack of control if he or she utilizes an income approach and the benefit stream is already on a minority basis.

- Regulation: Closed-end funds are regulated by the SEC; the FLP investor enjoys no such protection.
- Diversification and size: The FLP portfolio may not have the same level of diversification as a closed-end fund. One can look at specialized funds which invest in one industry as a comparison. FLPs are often very tiny compared to closed-end funds. This might increase the discount.
- Investment objective: A FLP portfolio may reflect no defined investment policy or objectives. This may be a lack of professional management.
- Quality: Speculative versus investment grade. Recall, however, that the security's market price should reflect the market's opinion as to its overall quality. Avoid double counting in the discount.
- Performance: If the FLP has been in existence for a while, its total return might be compared with that of various similar closed-end funds.
- Average maturity: For fixed income portfolios, average maturity of the bonds will affect their market values. Again, this factor should be addressed in the price of the security.

However, recent court cases have frowned on adjustments to the lack of control discount because they cannot be supported. Recent decisions have used an average or median discount of the selected funds. Valuation analysts often use the median discount because it eliminates outliers from the data. However, if you have already eliminated the outliers, you may be overcompensating by using the median of a smaller group of funds. Therefore, be consistent with the data that is used.

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

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

Data on this market has been gathered by Partnership Profiles, Inc. since 1990. Partnership Profiles issues a bi-monthly publication entitled *Direct Investment Spectrum* which offers general commentary about the secondary market for RELPs and REITs. Operating data for five years are provided where available, including information on cost of properties owned, percentage leverage, gross revenues, net income, cash flow, working capital, and a history of distributions to partners.

This data can be accessed through their Minority Interest database at www.partnershipprofiles.com. An annual subscription can be purchased for unlimited searching of their data.

The following factors can influence the price of a RELP in the secondary market.

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

Whether or not a FLP has a history of making distributions is an important consideration in determining the discount. Generally, partnerships which make distributions trade at smaller discounts to their NAVs, all other

things being equal. The amount of debt is important as well. If the appraisal FLP has no debt, it should be compared to partnerships that have little or no debt as well.

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

Discount for Lack of Marketability: An additional adjustment is often made to account for the fact that there is no secondary market for FLP interests, nor is one ever likely to develop. These interests lack marketability; that is, they cannot be liquidated or converted to cash quickly. If one owns shares of a publicly traded corporation, one may call a broker, sell the shares and have the cash proceeds within a few business days. Not so with FLP interests, and this is the basis for the discount for lack of marketability or DLOM.

In addition to the lack of a secondary market for FLP interests, certain provisions are often written into FLP agreements restricting the transfer of interests, especially to individuals or entities outside the family circle. These restrictions create an additional lack of marketability factor. Some of them are:

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

Other Provisions Affecting Marketability

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

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

If there is nothing in the Agreement that addresses the 754 election, it does not mean that the partnership cannot make the election. It still can. However, a willing buyer might wish to have assurance that such an election will be made. This is especially critical if the appraised fair market value of the underlying assets of the partnership have increased in value over their original basis. Since there is considerable record keeping involved once this election is made, a FLP may be reluctant to make the election. However, the courts seem to believe that a buyer would never purchase without making sure that a 754 election is in place, so although many smaller partnership do not and will not make a 754 election, the courts will not necessarily accept this as a legitimate reason for increasing the discount.

When valuing a general partner interest, some consideration may be given to an additional marketability factor reflecting the liability exposure assumed by the general partner and that under many states' partnership statutes, a majority of the limited partners may remove a general partner that assigns all of the general partner's interest in a FLP to a third party. Here, the analyst must read the Partnership Agreement carefully to

determine under what circumstances a general partnership may be transferred or whether, after withdrawal of a general partner, that general partner interest becomes a limited partner interest. In this case, the DLOM might be increased.

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

Sources of Marketability Discounts: The sources for discounts for lack of marketability for FLP assignments are the same as for all valuation assignments, restricted stock studies and pre-IPO transactions. The valuation analyst starts with these studies and then needs to address the facts and circumstances of the specific valuation assignment to determine the adjustments to the"benchmark" discount that will be utilized in the assignment at hand. However, the analyst can also use the Quantitative Marketability Discount Model (QMDM) to quantify the methodology. Others use the *Mandelbaum*[5] factors which include the following:

1. Financial statement analysis
2. Company's dividend policy
3. Nature of the company, its history, its position in the industry and its economic outlook
4. Company's management
5. Amount of control in transferred shares
6. Restrictions on transferability of stock
7. Holding period for stock
8. Company's redemption policy
9. Costs associated with going public

There are several other lists lists of factors to consider that have been published. The first comes from *Guide to Business Valuations* (p. 14-34):

> Some of the factors that would cause an interest to trade at a low marketability discount include–
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> 1. Minimal volatility in the value of the underlying assets.
> 2. Above average expectations for future yield.
> 3. A proven and stabilized history of income.
> 4. Certainty of distributions or expectation of capital appreciation.
> 5. Limited time period on restriction of ability to sell the interest.
> 6. Favorable outlook for future growth of the entity.
>
> Factors that would cause an interest to trade at a higher discount include–
>
> 1. High degree of volatility in the value of the underlying assets.
> 2. Questionable ability to generate a satisfactory return on assets.
> 3. Inability to generate sufficient earnings for distributions or to support future growth in operations.
> 4. Small size in relation to other investments and lack of diversification.
> 5. Involvement in industries or activities viewed unfavorably by the investing public.

5 *Mandelbaum v. Commissioner*, T.C. Memo 1995-255 (Affd. 91F.3d 124, 3rd Circuit, 1996)

The second comes from an article published by Robert E. Moroney entitled “Why 25% Discount for Nonmarketability in One Valuation, 100% in Another?”[6] In Moroney’s article, he points out 11 different factors that should be considered in the application of a DLOM. Some of the are very similar to the *Mandelbaum factors.* They are as follows:

1. High dividend yield: Companies that pay dividends tend to be more marketable than companies that do not.
2. Bright growth prospects: Companies that have bright growth prospects are easier to sell than companies that do not. This makes them more marketable.
3. Swing value: If a block of stock has swing value, it may be more marketable than the typical small block of stock. This swing value could include a premium. This can be emphasized where a 2 percent interest exists with two 49 percent interests. The 2 percent interest can be worth quite a bit to either 49 percent interest if it will give that interest control of the company.
4. Restrictions on transfer: Restrictions on transfer make the stock less marketable due to the difficulty in selling them.
5. Buy-sell agreements: Buy-sell agreements can go either way. The agreement can create a market for the stock, making it more marketable, or the agreement can restrict the sale making it less marketable.
6. Stock’s quality grade: The better the quality of the stock, the more marketable it will be. This can be evidenced by comparing the subject company to others for supporting strengths and weaknesses.
7. Controlling shareholder’s honesty: The integrity of the controlling shareholder can make a big difference regarding the ability to sell a partial interest in a company. If the controlling shareholder tends to deal with the other shareholders honestly, the other interests in that company tend to be more marketable.
8. Controlling shareholder’s friendliness: Similar to the shareholder’s honesty, the manner in which he or she deals with others can make the stock more marketable.
9. Prospects for the corporation: If a corporation has good prospects for the future, it will generally be more marketable.
10. Prospects for the industry: A company that is in an industry with good prospects will also generally be more marketable.
11. Mood of the investing public: When the investing public is bullish, they are more readily willing to make an investment. This can increase the marketability.

However use of any of these “lists,” is a benchmarking technique which the courts have been frowning on. They want the valuation analyst to explain why the studies are relevant to the particular valuation subject.

One additional source of data are two databases that include specific restricted stock and pre-IPO transactions. Resold by Business Valuation Resources and located at www.bvmarketdata.com, they are available by subscription. They are:

a. FMV Restricted Stock Study: This database currently contains 475 total transactions; including 205 transactions in Manufacturing, 138 transactions in Business Services, 45 transactions in Finance, Insurance and Real Estate, and 25 transactions in Transportation, Communications, Electric, Gas and Sanitary services
b. Valuation Advisors Lack of Marketability Discount Study (pre-IPO): As of July 2007, this database contained 3,547 transactions and over 1,470 companies dating from 1995 to 2006. No breakdown of data by SIC Code was provided.

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6 *Taxes*, May 1977.

Other Potential Adjustments: There are several other adjustments that may be included in determining a final value. Some of these adjustments may apply to the value of the underlying assets, rather than to the value of a FLP interest. In some cases, these are factors that are considered in the quantification of DLOM, rather than being included as a separate discount.

1. *Fractional interest adjustment*: The fair market value of an undivided ownership interest in real property is worth something less than the percentage of ownership multiplied by the fair market value of the real property as a whole. Fractional interest adjustments should not be limited to undivided interests in real property, but should be considered any time a fractional interest is held in any type of property.
2. *Portfolio Adjustment*: The basis for a portfolio adjustment is a FLP with a non-diversified portfolio of marketable securities.
3. *Restricted Securities Adjustment*: Restricted securities are those that are acquired from an issuer in a transaction exempt from registration requirements of federal and state securities laws (known as “private placements”). There are also restrictions imposed by the SEC. on resales of these restricted securities. Several Court cases have upheld additional discounts to account for restricted securities, but if the price of the security already reflects such a discount, it should not be taken twice.
4. *Blockage Adjustment*: This adjustment accounts for the depressive effect of suddenly placing a large block of stock or real estate on the market.
5. *Adjustment for Built-In Capital Gains Tax*: Under the willing buyer-willing seller test, adjustment may be made for the fact that the underlying assets may now have a market value greater than book value and that there may be a built-in capital gain with respect to those assets. If so, a willing buyer might become responsible for capital gains tax when the assets were sold. A hypothetical willing buyer would take this into consideration when evaluating a FLP interest. This issue is also related to the Section 754 election.

THE REPORT: One useful way to present a report is to set it following the eight factors of Revenue Ruling 59-60. Remember, the ultimate “user” of your report is the Internal Revenue Service. By laying out your report in the order of the eight factors, you are showing the service that you are considering each of the factors that they have laid out in their ruling. In addition, you should include sections relating to capitalization and discount rates, if appropriate, as well as discounts and premiums.

The AICPA’s *Statement on Standards for Valuation Services* states the following:

> 51. The *detailed report* is structured to provide sufficient information to permit intended users to understand the data, reasoning, and analyses underlying the valuation analyst’s conclusion of value. A detailed report should include, as applicable, the following sections titled using wording similar in content to that shown:
>
> - Letter of transmittal
> - Table of contents
> - Introduction
> - Sources of information
> - Analysis of the subject entity and related nonfinancial information
> - Financial statement/information analysis
> - Valuation approaches and methods considered
> - Valuation approaches and methods used
> - Valuation adjustments
> - Nonoperating assets, nonoperating liabilities, and excess or deficient operating assets (if any)
> - Representation of the valuation analyst
> - Reconciliation of estimates and conclusion of value
> - Qualifications of the valuation analyst
> - Appendices and exhibits

The valuation analyst should also consider following the Internal Revenue Service's Adequate Disclosure Rules as laid out in Regulation Section 301.6501. Essentially, the Internal Revenue Service is telling the valuation analyst that to "pass muster," we must present a fully supported and documented report. This is not substantially different from the AICPA's Standard, or USPAP....do your work and report it.

Do not have the reader of the report have to guess about your methodology, discounts, or conclusions. For example, you do not want to state...the studies indicate 25 to 45 percent, therefore, we selected 35 percent. This is not supported. There are numerous court cases which disallow discounts, strictly because the valuation analyst did something similar to this. You should select a benchmark discount and then adjust it based on specific items that you discussed in detail in your report.

CONCLUSION: In conclusion, I would like to emphasize the importance of our role as valuators. We believe it is important that the valuation analyst not cross the line from being an independent valuation analyst to being an advocate of bigger and bigger discounts. This can happen, especially if a client requests that we review a partnership document with an eye to adding restrictions and provisions that might increase the discounts.

Although advising an attorney on the provisions of the agreement is really outside of the scope of the valuation analyst's assignment, this does not excuse valuation analysts from being aware of the law, especially state laws regarding limited partnerships, and limited liability companies. Key questions to review with the partnership's attorney might include:

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

These issues can impact the valuation opinion. It is important for the analyst to remember that his or her assignment is the determination of fair market value. This means the consideration of both a hypothetical willing buyer, as well as a hypothetical willing seller. Your final opinion of value must be reasonable. Remember, the buyer might buy for that low a price, but as an independent analyst, you must also ask yourself the question, if I was the seller, would I sell that low?

The remainder of this paper includes sections of some of Trugman Valuation Associates, Inc.'s LLC reports which provide examples of some of the things discussed in this paper.

Example 1: The Agreement

FORMATION OF THE LLC: *Smith Investment LLC II, a Delaware Limited Liability Company ("Smith" or "The LLC"), was formed in accordance with the Delaware Limited Liability Act ("The Act") on November 29, 2004. The Certificate of Formation of The LLC was filed with the Secretary of State of Delaware on November 29, 2004, and The Company Agreement ("The Agreement") was signed on the same day.*

PURPOSE OF THE LLC: *Smith was formed to invest in real estate, stocks, bonds, partnership interests, and other securities and financial instruments. The LLC can also engage in any other lawful purpose that is approved by its Management Committee.*

TERM OF THE LLC: *The term of The LLC shall continue indefinitely unless its existence is terminated sooner pursuant to Section 8 of The Agreement.*

VOTING: *Except as otherwise provided in The Agreement, wherever The Agreement requires approval of the members, the affirmative vote of more than 50 percent of the aggregate of all percentages held by members is required to approve a*

matter. Only percentages held by members in their capacity as members, not merely assignees or transferees can be voted.

OWNERSHIP INTERESTS AND CAPITAL CONTRIBUTIONS: *Upon formation, the members' ownership interests in The LLC were distributed as follows:*

Partner	Percentage Interest	Capital Contributions
Louis Smith	49.00%	$ 490.00
Doris Smith	51.00%	510.00
Totals	**100.00%**	**$ 1,000.00**

No member is required to make additional capital contributions. Subsequent to the formation of The LLC, the members transferred various marketable securities into The LLC. Each member transferred an amount proportionate to his/her membership interest, so the member's percentage interests remained the same.

On December 31, 2005, Doris Smith sold 49 percent of her interest to Smith Investment LLC at fair market value established by a valuation as of the same date. On January 31, 2006, Louis Smith sold his 49 percent interest to Smith Investment LLC at fair market value established by a valuation as of the same date. At the valuation date, ownership is as follows:

Members	Percentage Interest
Doris Smith	2.00%
Smith Investment LLC	98.00%
Total	**100.00%**

ALLOCATIONS OF PROFITS AND LOSSES: *Profits and losses shall be allocated to the members in accordance with his or her percentage interest in Smith, after giving special effect to the special allocations set forth in Sections 5.3 and 5.4 of The Agreement, which are regulatory and curative. Regulatory allocations arise out of the income tax regulations, and curative allocations are made to offset the effect of the regulatory allocations.*

DISTRIBUTIONS: *Cash flow and net capital proceeds may be distributed to the interest holders at the discretion of the Management Committee, but no distributions may be made if they impair the reasonable working capital needed for conducting The LLC's business and affairs. Distributions, when made, will be in accordance with each interest holder's percentage interest in Smith. An "interest holder" is any person who holds an interest, whether as a member or an unadmitted assignee.*

MANAGEMENT: *The management of Smith is vested in a Management Committee designated by the members of The LLC. The initial number of managers on the Management Committee will be one unless the members provide otherwise. The initial manager will be Anthony F. Jones. In the event that Anthony F. Jones is unable to serve as manager, Janet A. Jones will automatically assume the role of successor manager.*

A manager may be removed from the Management Committee for any reason, or for no reason and at any time, by a vote of the members. If there are multiple managers, each manager shall have one vote, and the Management Committee shall act by the affirmative vote of a majority of the members of the Management Committee.

The Management Committee has the authority to manage, control, administer, and operate the business and affairs of The LLC. However, the Management Committee is not permitted to do the following without the approval of members holding more than 50 percent of the percentages held by members:

1. *Admit a new member,*
2. *Make loans or guarantee loans of any manager or affiliate of a manager, and,*
3. *Enter into a borrowing on behalf of The LLC, which when added to all other indebtedness, will exceed $10,000.*

The Management Committee may take any action, except those described above, without a meeting of the members, as long as such action is approved by the unanimous written consent of the Management Committee.

TRANSFER RESTRICTIONS: *Section 7.1(a) of The Agreement defines the following six conditions which must be met before a transfer of any member interest can be made:*

1. *The transfer will not require registration under any federal or state securities laws.*
2. *The transferee agrees in writing to be bound by the terms of The Agreement.*
3. *The transfer will not result in termination of The LLC under Internal Revenue Code Section 708.*
4. *The following information is delivered to The LLC by either the transferor or the transferee:*
   a. *Transferee's taxpayer identification number, and*
   b. *Transferee's initial tax basis in the transferred interest.*
5. *The transferor or the transferee must pay a transfer fee to The LLC to cover all reasonable expenses in connection with the transaction if required by the Management Committee.*
6. *The transferor complies with the provision of The Agreement concerning rights of first refusal.*

Only if the above conditions are satisfied can a transfer take place. The only transfers that do not have to satisfy these conditions are "permitted transfers" as described in Section 7.2. These involve transfers between members, their spouse, children, or any company or entity owned by a member.

For all but permitted transfers, The LLC and other interest holders retain a right of first refusal. That is, prior to offering his or her interest to a third party in other than a permitted transfer, he or she must first offer the interest to The LLC and to other interest holders. The offer is good for 30 days. As provided in Section 603 of The Act, a member shall not have the right to resign prior to dissolution and winding up of The LLC. The transferee may become a substituted member and have full membership rights if Section 301(b) and 704(a) of The Act have been satisfied.

DISSOLUTION AND LIQUIDATION: *Any liquidation of The LLC must be approved by a vote of all of the interest holders. All liquidations must be made in cash. If The LLC is dissolved, the Management Committee must wind up The LLC's affairs. Smith's assets will be distributed first to creditors, then to interest holders according to their positive capital accounts, and then to interest holders according to their percentages.*

Example 2: Valuation Calculations Section – Marketable Securities

<u>VALUATION CALCULATIONS</u>

As mentioned earlier, the three approaches to valuation considered in any appraisal are:

1. *The Market Approach,*
2. *The Asset Based Approach, and*
3. *The Income Approach.*

Each of these methods was previously described.

THE MARKET APPROACH

The market approach was not used for this appraisal because we were unable to locate publicly traded or privately held companies that would have been useful in making comparisons with The Company. In the previous section, we discussed the search for closed end mutual funds whose shares were actively traded on a public exchange. The search did not reveal enough useful guideline companies or transactions to make this approach applicable.

ASSET BASED APPROACH

ADJUSTED BOOK VALUE METHOD

Revenue Ruling 59-60 states, "The value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock." Therefore, the asset based approach, specifically the adjusted book value method was applied to value an assignee interest in The LLC.

It has previously been determined that the adjusted book value of The LLC is $19,886,117. This reflects the value of The LLC on a control, marketable basis.

We were retained to determine the value of a 1 percent interest in The LLC on a minority, non-marketable basis. In order to derive this value, we must apply a lack of control or minority discount, as well as a discount for lack of marketability. These discounts are discussed in the "Premiums and Discounts" section of this report.

Applying these discounts results in the following calculation of value:

Total Enterprise Value	*$*	*19,886,117*
Less: Discount for Lack of Control (5%)		*(994,306)*
Minority, Marketable Value	*$*	*18,891,811*
Less: Discount for Lack of Marketability (30%)		*(5,667,543)*
Minority, Non-Marketable Value	*$*	*13,224,268*
Calculated Interest		*x 1%*
Value of a 1% Member Interest	***$***	***132,243***
Rounded	***$***	***132,000***

THE INCOME APPROACH

As stated earlier, the income approach is accomplished by either capitalizing a single period income stream or by discounting a series of income streams based on a multi-period forecast. It has previously been determined that the earnings and dividend paying capacity cannot be quantified at this time. Therefore, the income approach could not be utilized.

CONCLUSION

To test the reasonableness of the conclusion of value, the valuation analyst performed a return on investment analysis. As previously discussed, Jones's portfolio is currently generating a return of approximately 2.6 percent without considering capital gains and losses; this equates to dividend and interest income on an annual basis of approximately $509,209. However, according to the brokerage statement, interest and dividends should amount to approximately $811,000, which is an income return of about 4.0 percent.

If a willing buyer paid $132,000 for a 1 percent interest, he/she would receive a return of approximately 6.1 percent on an annual basis, if it is assumed that annual income is approximately $811,000 per year.

The valuation analyst located alternative rates of return in Ibbotson Associates' Stocks Bonds Bills & Inflation - Valuation Edition 2006 (SBBI). This data is presented in the following table:

	Income Returns	***Capital Appreciation***	***Total Return***
Large Company Stocks	*4.2%*	*7.8%*	*12.3%*
Mid-Cap Stocks	*4.1%*	*9.8%*	*14.2%*

Low-Cap Stocks	*3.7%*	*11.7%*	*15.7%*
Micro-Cap Stocks	*2.6%*	*16.1%*	*18.8%*
Long-Term Corporate Bonds	*N/A*	*N/A*	*6.2%*
Long-Term Government Bonds	*5.2%*	*0.4%*	*5.8%*
Treasury Bills	*N/A*	*N/A*	*3.8%*

N/A = not provided.

The return on investment of 6.1 percent calculated on the previous page consists only of income returns. What is not included in the data provided by Ibbotson Associates are the returns on municipal bonds. Research for the first quarter of 2006 indicates that total returns for 10 year single-state municipal bonds were just over 4 percent.[7] Another source indicates that 20 year state and local bonds on a national basis are returning 4.44 percent.[8] However, another source indicates that AAA Insured Municipal Bonds on a national basis are returning 3.95, 4.30 and 4.33 percent for 10, 20 and 30 year bonds, respectively.[9] This range of returns reflects total returns, but as can be seen above, most of the return on bonds is an income return.

Return on investment is derived from a combination of annual returns (distributions of income) and growth in the entity. However, an investor in Jones may not receive an annual return, as the Management Committee does not have to make cash distributions, and to date, it has not. Instead, an investor in Jones would look for growth in the portfolio, as he/she would receive an appreciated amount at the time The LLC is terminated. Since the life of The LLC is perpetual, this event can be many years in the future.

From the table on the previous page, it is clear that on the 30 percent (approximately) of the portfolio that is not invested in cash or bonds, the growth (capital appreciation) has historically exceeded 5.9 percent. Although the asset classifications provided in SBBI do not include all of the asset classes contained in the Jones portfolio, it can be used as a guide to show the range of growth that equity portfolios have shown over the long term.

A buyer of an interest in Jones has alternatives. He or she can take the $132,000 investment and purchase an equity portfolio that would generate a total long-term return between 12 and 18 percent. This investment could be generated from a portfolio of marketable securities, and the investor would have liquidity.

However, the hypothetical seller of this interest will not walk away from his investment unless he or she also receives a return on his investment. So, if the value derived is too low (in other words, the buyer requires a 12 to 18 percent return), there would be no enticement for a seller to consummate a deal. Therefore, the willing buyer and seller would look for returns that would meet both of their investment criteria.

This analysis considers both the buyer and seller and supports the value concluded under the asset based approach. Therefore, the value of a 1 percent interest in Jones as of March 31, 2006 is $132,000.

Example 3 – Valuation Calculations Section – Real Estate

VALUATION CALCULATIONS

As mentioned earlier, the three approaches to valuation considered in any appraisal are:

1. *The Market Approach,*
2. *The Asset Approach, and*
3. *The Income Approach.*

Each of these methods was previously described.

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7 "Muni Outlook," Municipal Market Advisors (January 2006).

8 Federal Reserve Statistical Release <http://www.federalreserve.gov/RELEASE/h15/ 20060403/>.

9 http://www.fmsbonds.com/yields.html.

THE MARKET APPROACH

The market approach was not used for this appraisal because the valuation analyst was unable to locate publicly traded or privately held companies that would have been useful in making comparisons with The LLC.

THE ASSET APPROACH

ADJUSTED BOOK VALUE METHOD

Revenue Ruling 59-60 states, "The value of the stock of a closely-held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock." Therefore, the asset approach, specifically the adjusted book value method was applied to value the member interests in The LLC.

It has previously been determined that the adjusted book value of The LLC is $4,870,692. This reflects the value of The LLC on a control, marketable basis.

The valuation analyst was retained to determine the values of a 13.96 percent member interest and a 3.4577 percent member interest in The LLC on a minority, non-marketable basis. In order to derive this value, we must apply a discount for lack of control, as well as a discount for lack of marketability. These discounts are discussed in the "Premiums and Discounts" section of this report.

Applying these discounts results in the following computation of values:

	13.96%	**3.4577%**
Net Asset Value	*$ 4,870,692*	
Less: Discount for Lack of Control (19%)	*(925,483)*	
Minority, Marketable Value	*$ 3,945,479*	
Less: Discount for Lack of Marketability (27%)	*(1,065,279)*	
Minority, Non-Marketable Value	*$ 2,880,200*	
Interest to Be Valued	*13.96%*	*3.4577%*
Value of Interest	***$ 402,076***	***$ 99,589***
Rounded	***$ 402,000***	***$ 100,000***

THE INCOME APPROACH

As stated earlier, the income approach is accomplished by either capitalizing a single period income stream or by discounting a series of income streams based on a multi-period forecast.

In previous sections of this report, the valuation analyst discussed earning and dividend paying capacity. An estimate of earning capacity and dividend paying capacity was calculated based on the historic information and the terms of the leases. This information will be used in a discounted future benefits method to calculate a value under the income approach.

DISCOUNTED FUTURE BENEFITS METHOD

The discounted future benefits method is one of the most theoretically correct methods of appraisal. It is premised on the concept that value is based on the present value of all future benefits that flow to an owner of a property. These future benefits can consist of current income distributions, appreciation in the property, or a combination of both. The formula for the discounted future benefits method is as follows:

$$\sum_{n=1}^{n=t} \frac{B_n}{(1+i)^n} + \frac{TV_t}{(1+i)^t}$$

Where

B	=	*Forecasted benefit stream.*
n	=	*Year in which the benefit stream is achieved.*
i	=	*Required rate of return.*
TV	=	*Terminal value, which is the estimated value of the benefit stream after the forecast period.*
t	=	*Year of stabilization.*

The formula appears much more complicated than it is. In essence, this valuation method requires a forecast to be made of future benefits, going out far enough into the future until an assumed stabilization occurs for the property being appraised.

The earnings for 2006 reflect the entire year. The LLC provided a compiled income statement for the period ended June 30, 2006. By annualizing the net income figure, net income at August 28, 2006 is approximately $55,804. Forecasted net income for the entire year is $79,020. Therefore, earnings for the remainder of 2005 is $23,216, and net cash flow for the remainder of the year is $56,216.

Once the benefits stream has been forecast, the selection of a proper discount rate becomes necessary. Since the benefit stream being estimated will not occur until some time in the future, the future benefits must be discounted to their present values. In this instance, a discount rate of 21 percent has been deemed applicable (see section of this report entitled "Discount and Capitalization Rates"). This results in a value estimate of RealCo. as follows:

Year	***Forecasted Net Cash Flow***	***21% Present Value Factors***	***Present Value of Future Net Cash Flow***
2006	*$ 56,216*	*0.9843*	*$ 55,334*
2007	*288,191*	*0.8801*	*253,638*
2008	*334,730*	*0.7274*	*243,469*
2009	*380,949*	*0.6011*	*228,997*
TV	*2,179,876*	*0.6011*	*1,310,373*
Minority, Marketable Value			*$ 2,091,811*
Less: Discount for Lack of Marketability (27%)			*(564,789)*
Minority, Non-Marketable Value			*$ 1,527,022*

	13.96%	***3.4577%***
Minority, Non-Marketable Value	*$ 1,527,022*	*$ 1,527,022*
Interest to be Valued	*x 13.96%*	*x 3.4577%*
Value of Interest	***$ 213,172***	***$ 52,800***
Rounded	***$ 213,000***	***$ 53,000***

In this instance, the terminal value is calculated by growing the last year's forecasted benefit stream by a stabilized growth rate. The result is then capitalized and discounted to its present value. Once again, this appears to be very complicated, but it is consistent with the Gordon Growth Model used in the securities market. The benefit stream used in the calculation of the terminal value is the stabilized benefit stream expected to be achieved by The LLC after the forecast period. The stabilized stream is capitalized into the future, and then reduced to its value at the appraisal date.

(Discount rates, capitalization rates and a discussion of growth rates can be found in the report section entitled "Discount and Capitalization Rates").

CONCLUSION OF VALUE

Several methods were used to derive values in this appraisal. They were as follows:

	13.96%	**3.4577%**
Asset Approach		
Adjusted Book Value	*$ 402,000*	*$ 100,000*
Income Approach		
Discounted Future Earnings	*213,000*	*53,000*

In a minority valuation, the minority owner cannot force the sale of the underlying assets to obtain the value of the real estate. However, the value of the assets cannot be ignored.

The income approach is the most theoretically correct method of valuing a property as it considers the earnings and cash flow being generated from the property. However, in this case the rents charged for the 275 Route 46 property are below market and do not support the value of the real estate. However, it more closely reflects the value to a minority owner because it reflects monies available to the minority owner who cannot force the sale of the underlying real estate.

Based on the facts and circumstances of the appraisal, the valuation analyst put more weight on the asset approach but did not ignore the fact that the minority owner cannot force the sale of the assets and his/her return is based on the income and cash flow derived by The LLC. Therefore, the value of a 13.96 percent interest in RealCo. Industrial III, LLC is deemed to be $355,000, and the value of a 3.4577 percent interest is deemed to be $88,000.

To test the reasonableness of the opinion of value, the valuation analyst performed a return on investment analysis. From 2002 through 2005, average distributions were approximately $138,700. A 13.96[10] percent owner would have received $19,363 per year. Based on a purchase price of $355,000, the investor's annual rate of return would be 5.5 percent. However, this is strictly an income return and does not consider growth.

In a later section of this report, rates of return on various real estate investments are discussed. These are summarized below:

	Average	**Median**
Real Estate		
Closed End Funds[11]	*9.5%*	*12.0%*
Publicly-Traded Real Estate		
Limited Partnerships (2005)	*19.8%*	*19.1%*

In addition, Ibbotson Associates reports the following returns for other types of investments:

Large Company Stocks	*12.3%*
Mid-Cap Stocks	*14.2%*
Low-Cap Stocks	*15.7%*
Micro-Cap Stocks	*18.8%*
Long-Term Corporate Bonds	*6.2%*

10 Although the example is based on the 13.96 percent interest, had the value of the 3.4577 percent interest been used, the results would have been the same.

11 Many of these are relatively new funds, and do not have a long-term record of returns on investment.

Long-Term Government Bonds	*5.8%*
Treasury Bills	*3.8%*

Source: Stock Bonds Bills & Inflation - Valuation Edition 2006: 28.

What this data shows is that an investor has alternatives and different alternatives pay different levels of returns. The minimum return indicated above is a riskless investment in Treasury Bills yielding 3.8 percent. A long-term government bond, which must be held for 20 years in order for an investor to receive the full return yields almost 50 percent more than a three month investment. This is another indication that an investor expects a higher rate of return when the investment is long-term. An investor also expects a higher rate of return when the investment is considered to be more risky.

Based on the alternative rates of return, a return of 5 percent for an investment in RealCo. is at the low end of the range. This is to be expected because it does not include growth and there is no diversification in the portfolio, which increases the level of risk. To obtain a higher rate of return, a willing buyer would want to pay less for the investment (higher discounts), but a willing seller would most likely not be willing to sell it for considerably less. However, the value derived is within the range of other investments, and therefore the value derived is considered to be reasonable.

DISCOUNT AND CAPITALIZATION RATES

Section 6 of Revenue Ruling 59-60 states:

> *In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation.*

In the text of Revenue Ruling 68-609, capitalization rates of 15 to 20 percent were mentioned as an example. Many valuation analysts are under the misconception that the capitalization rate must stay within this range. In reality, the capitalization rate must be consistent with the rate of return currently needed to attract capital to the type of investment in question.

There are various methods of determining discount and capitalization rates. Using the build up method of determining these rates results in the following:

Appraisal Date Long-Term Treasury Bond Yield			*5.01*[1]
Real Estate Risk Premium			
1994-2005 Publicly Held LP Return	*18.60*[2]		
1994-2005 Government Bond Income Return	*- 5.88*[3]		
Average Market Return		=	*12.72*
Adjustments for Other Risk Factors		+	*3.00*[4]
Discount Rate for Net Cash Flow		=	*20.73*

CAPITALIZATION RATES

Discount Rate for Net Cash Flow		*20.70*
Growth Rate	-	*3.00*
Capitalization Rate for Net Cash Flow	=	***17.70***
Rounded	=	***18.00***

1. *Federal Reserve, Market Yield on U.S. Treasury Securities at 20-year constant maturity as of August 28, 2006 <http://www.federalreserve.gov/releases/h15/data/ Business_Day/H15_TCMNON_Y20.txt>.*

2. 2006 Rate of Return Study, Partnership Profiles, Inc. The expected return for publicly-held limited partnerships traded in the informal secondary market for 1994 through 2005.

3. Long-Term Government Bonds: Income Returns, Stocks Bonds Bills & Inflation - Valuation Edition 2006 Yearbook. The average income returns for 1994 through 2005.

4. Valuation analyst's judgment based on the analysis discussed throughout the report.

A capitalization rate has been derived from a discount rate, which has been calculated above. The components of the discount rate include a safe rate which indicates the fact that any investor would receive, at a bare minimum, an equivalent rate for a safe investment. In this particular instance, United States Treasury Bonds are used as an indication of a safe rate.

A real estate risk premium is added to the safe rate which represents the premium that investors receive in the secondary market for real estate limited partnerships over investors in long-term government bonds. Since publicly-traded limited partnerships are considered to be more risky by the investor, a higher rate of return is required over the period 1994 through 2005.

An adjustment has also been made for other risk factors specific to the valuation subject. This additional level of risk is added to reflect the size of the entity in comparison to the limited partnerships, the lack of diversification (based on the number of holdings) and the lack of professional management. In addition, one of The LLC's properties is vacant as of the valuation date and although the property manager is confident about the ability to obtain a new tenant, this increases the riskiness of The LLC's ability to generate the forecasted cash flow. Also, RealCo.'s historic earnings and cash flow have been erratic. For these reasons, investors would expect a greater rate of return on an investment in RealCo. than in a publicly-traded limited partnership. Therefore, 3 percent has been added to the discount rate to reflect this additional level of risk.

Summing all of these items results in the derivation of a discount rate. The mathematical formula to distinguish between a discount rate and a capitalization rate is the subtraction of the present value of long-term sustainable growth from the discount rate. The present value of the long-term sustainable growth has been included at a rate of 3 percent for RealCo.. This rate has been determined based on an estimated increase at the approximate rate of inflation.

Example 4 – Premiums & Discounts – Marketable Securities

PREMIUMS AND DISCOUNTS

VALUATION PREMIUMS AND DISCOUNTS IN GENERAL

The final value reached in the appraisal of a closely-held business interest may be more or less than the value that was calculated using the various methods of appraisal that are available. The type and size of the discount(s) or premium(s) will vary depending on the starting point. The starting point will depend on which methods of valuation were used during the appraisal as well as other factors, such as the sources of information used to derive multiples or discount rates, and normalization adjustments.

CONTROL PREMIUM / LACK OF CONTROL DISCOUNT

The pro rata value of a controlling interest in a limited liability company is said to be worth more than the value of a minority interest, due to the prerogatives of control that follow the controlling interest. An investor will generally pay more (a premium) for the rights that are considered to be part of the controlling interest. Valuation professionals recognize these prerogatives of control, and they continue to hold true today. These rights are considered in assessing the size of a control premium. They include:

1. *Appoint or change operational management.*
2. *Appoint or change members of the board of directors.*
3. *Determine management compensation and perquisites.*
4. *Set operational and strategic policy and change the course of the business.*
5. *Acquire, lease, or liquidate business assets, including plant, property, and equipment.*
6. *Select suppliers, vendors, and subcontractors with whom to do business and award contracts.*

7. *Negotiate and consummate mergers and acquisitions.*
8. *Liquidate, dissolve, sell out, or recapitalize the company.*
9. *Sell or acquire treasury shares.*
10. *Register the company's equity securities for an initial or secondary public offering.*
11. *Register the company's debt securities for an initial or secondary public offering.*
12. *Declare and pay cash and/or stock dividends.*
13. *Change the articles of incorporation or bylaws.*
14. *Set one's own compensation (and perquisites) and the compensation (and perquisites) of related-party employees.*
15. *Select joint ventures and enter into joint venture and partnership agreements.*
16. *Decide what products and/or services to offer and how to price those products/services.*
17. *Decide what markets and locations to serve, to enter into, and to discontinue serving.*
18. *Decide which customer categories to market to and which not to market to.*
19. *Enter into inbound and outbound license or sharing agreements regarding intellectual properties.*
20. *Block any or all of the above actions.*[12]

A control premium is the opposite of a lack of control discount. The control premium is used to determine the control value of a closely-held business when its freely traded minority value has been determined. This is generally the case when the valuation analyst uses information from the public stock market as the starting point of the valuation.

In this case, a 1 percent limited liability company member interest, does not constitute a controlling interest. Control of the day-to-day management of Jones is held by the Management Committee of The LLC. This committee has exclusive authority and power to manage, operate and control the business of The LLC without the consent of any member or assignee. Therefore, a discount for lack of control is appropriate for this appraisal.

A lack of control discount is a reduction in the control value of the appraisal subject that is intended to reflect the fact that a minority owner cannot control the daily activities or policy decisions of an enterprise, thus reducing its value. The size of the discount will depend on the size of the interest being appraised, the amount of control, the owner's ability to liquidate the company, and other factors provided in the previous list.

Discounts for lack of control can be mathematically determined using control premiums that are measured in the public market. Data on control premiums is generally not available for closely-held businesses, so the valuation analyst often uses transactions from the public stock market to act as a gauge regarding the amount of premium paid in transactions involving buyouts. This data is tracked by several sources. The most widely used is Mergerstat Review, which is published annually by FactSet Mergerstat and has reflected implied discounts ranging from 19.0 to 30.8 percent from 1980 to 2004.

This data is for transactions of large operating companies in the public marketplace, and is not relevant to a limited liability company that invests in a portfolio of marketable securities.

There are many factors that might impact the degree of control a partial (minority) owner has over the operations of a company. Whenever the control elements are not available to the ownership interest being valued, the value is reduced accordingly. Table 2 (written for corporations, yet applicable to limited liability companies) summarizes some of the factors that tend to influence the value of minority shares relative to control shares:

TABLE 2
FACTORS AFFECTING THE DEGREE OF CONTROL[13]

Factors That May Increase A Minority Interest Discount or Control Premium

- *The presence of nonvoting stock.*
- *An extreme lack of consideration for the interests of minority shareholders on the part*

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12 *Pratt, Shannon P., Robert F. Reilly, and Robert P. Schweihs. Valuing a Business, 4th Edition (New York: McGraw-Hill, 2000), pp. 365-366.*

13 *Guide to Business Valuations, Practitioners Publishing Company, Inc., 2001, p. 8-19, 803.16.*

of the company's management, board of directors, and/or majority owners.

Factors That May Decrease a Minority Interest Discount or Control Premium

- *The presence of enough minority interest votes to elect or have meaningful input on electing one or more directors in a company with cumulative voting.*
- *The presence of enough minority votes to block certain actions (subject to state statutes and/or articles of incorporation)*
- *The presence of state statutes granting certain minority stockholder rights.*

Factors That May Increase OR Decrease a Minority Interest Discount or a Control Premium.

- *The distribution of other shares (e.g. two shares when others own 49 shares each are more valuable than two shares when 49 others own two shares each).*

The net asset value of The LLC was used to determine the control value of the entire entity. However, to realize this value, an investor would need to be able to gain access to, and liquidate, the underlying assets of The LLC. If members were afforded this level of control, member interests might well be worth a pro rata share of The LLC's net asset value. However, this is not the case in this valuation.

The Agreement specifically vests all decision making solely in the Management Committee. The basis for lack of control adjustments for limited liability company interests arises from a range of factors, which include:

- *Members generally cannot control the day-to-day management or operation of The LLC.*
- *Members generally cannot control the amount or timing of income distributions to other members.*
- *Members do not have specific claims on the underlying assets of The LLC, and they usually cannot compel the dissolution of a limited liability company or the liquidation of its underlying assets. In this case, The LLC has a perpetual life.*

- *It is usually very difficult for members to remove management.*
- *It is usually very difficult for members to amend a limited liability company agreement.*

The net asset value method develops a freely traded, control value of The LLC's net assets of $19,886,117 as of March 31, 2006, and does not, therefore, provide a meaningful indication of value for a minority interest in The LLC. A discount for lack of control is appropriate here because an interest in The LLC represents an indirect ownership interest in the underlying assets held by The LLC members.

One approach to determining an appropriate discount for lack of control is to compare the interest under appraisal to published control premium studies. This can be accomplished using publications such as Mergerstat Review, cited previously.
Another method of estimating the appropriate discount for lack of control for Jones is to draw a parallel between The LLC's portfolio and closed-end mutual funds (CEFs). Hundreds of closed-end funds are available for numerous specialized investment options. Prices paid for publicly-traded shares in a CEF represent minority interests in fully marketable securities. Therefore, if the net asset value of a CEF can be determined and compared with the freely-traded price of the fund, it can be determined when and under what conditions the market affords a discount (or premium) to the net asset value of a minority interest.

Unlike open-end mutual funds, CEFs issue a fixed number of shares. Therefore, investors must buy shares from other investors, not the fund itself. These CEFs mirror the motivations of buyers and sellers, and offer empirical evidence for determination of the appropriate magnitude of the minority interest discount to be applied.

As previously discussed, the portfolio of Jones consists of a number of different types of investments. The analyst located information about CEFs as of March 31, 2006 in the April 3, 2006 issue of Barron's. These funds contain investments that are similar to the various categories of assets owned by The LLC. Since none of the funds is the same as any of the specific assets held in the portfolio, the valuation analyst used all of the CEFs in a given category as a proxy for the marketplace in similar investments. The details of the discount information in the various categories are presented in Tables 3 through 11 (to save space, only the details of the first category were included).

Cash and money market funds invest in government bonds. Table 3 presents the U.S. Government Bond Fund Category.

TABLE 3
U.S. GOVERNMENT BOND FUND

Name	NAV	Mkt Price	Prem/Disc	52 Week Market Return
ACM Govt Oppty (AOF)	8.50	7.62	-10.4	+6.3
ACM Incm (ACG)	8.15	8.08	-0.9	+7.8
EnhncdGovernmentFd (EGF)	18.80	17.96	-4.5	NS
MFS Govt Mkts (MGF)	7.16	6.38	-10.9	+5.1
MS Govt Inc (GVT)	9.59	8.62	-10.1	+4.8
SlBrlfMgt (IMF)	17.79	16.27	-8.5	+8.3
WstrnAsst/ClymrUSTrsInfl (WIA)	12.97	11.34	-12.6	+7.6
WstAstClymrTips2 (WIW)	13.08	11.50	-12.1	+7.7
		Mean	**-8.8**	
		Median	**-10.3**	

General Equity Funds consist of funds that primarily invest in domestic (U.S.) equities. This data is presented in Table 4. Any funds that did not include pricing data have not been presented. Income and preferred stock funds are presented in Table 5. Jones owns several mutual funds that invest in New York municipal bonds. In addition, it owns a number of New York municipal bonds outright. These are single state funds, not investments in national bond funds. Table 6 contains the CEFs that invest in New York State Bonds.Corporate bonds are most similar to Investment Grade Bond Funds which are presented in Table 7. Jones owns several funds that invest in high yield bonds. Table 8 contains the relevant CEFs. CEFs that invest in world equity funds are presented in Table 9. CEFs that invest in world income funds are presented in Table 10. Barron's includes a list of specialized equity CEFs. Included in this category are 16 real estate funds that invest in real estate and/or equities in real estate companies and real estate investment trusts. These are presented in Table 11.Jones owns one fund that invests in national mortgage bond funds. However, the amount is so negligible, that any discount applied would have no affect on the overall discount.

Utilizing the information on the previous pages, the valuation analyst calculated a blended or weighted discount for lack of control utilizing the median discounts of the various asset classes. The median was selected as it eliminates the outliers from the data that can skew the results. The calculation of the discount is presented in Table 12.

TABLE 12

	% of Portfolio	x	Discount	=	Weighted Average
Cash, Money Market and U.S. Gov't Bond Funds	4.85%		10.3		0.50%
U.S. Common Stocks	17.95%		6.9		1.24%
Income & Preferred Stocks	1.83%		8.4		0.15%
Municipal Bonds	66.08%		3.6		2.38%
Corporate Bonds	0.45%		7.0		0.03%
High Yield Bond Fund	0.63%		3.8		0.02%
World Equity Funds	7.20%		5.9		0.42%
U.S. Mortgage Bond Funds	0.00%		9.3		0.00%
World Income Funds	0.19%		7.0		0.01%
Real Estate	0.82%		15.50		0.13%
	100.00%				**4.89%**
			Rounded		**5.00%**

There are a number of differences between the closed-end funds and Jones including but not limited to size, management and distributions that could justify a higher discount. However, there is no quantitative methodology to support a higher discount. Therefore, based on the analysis performed, a discount for lack of control of 5 percent was deemed appropriate.

DISCOUNT FOR LACK OF MARKETABILITY

A discount for lack of marketability (DLOM) is used to compensate for the difficulty of selling shares of stock that are not traded on a stock exchange compared with those that can be traded publicly. If an investor owns shares in a public company, he or she can pick up the telephone, call a broker, and generally convert the investment into cash within three days. That is not the case with an investment in a closely-held company or LLC. Therefore, publicly traded stocks have an element of liquidity that closely-held shares do not have.

This is the reason that a DLOM will be applied. It is intended to reflect the market's perceived reduction in value for not providing liquidity to the shareholder.

A DLOM may also be appropriate when the shares have either legal or contractual restrictions placed upon them. This may be the result of restricted stock, buy-sell agreements, bank loan restrictions or other types of contracts that restrict the sale of the shares. Even when a 100 percent interest is the valuation subject, a DLOM may be appropriate if the owner cannot change the restrictions on the stock.

The most commonly used sources of data for determining an appropriate level of a DLOM are studies involving restricted stock purchases or initial public offerings. Revenue Ruling 77-287 references the Institutional Investor Study,[14] which addresses restricted stock issues. Many studies have updated this one.

Restricted stock (or letter stock as it is sometimes called) is stock issued by a corporation that is not registered with the Securities and Exchange Commission (SEC) and cannot be readily sold into the public market. The stock is usually issued when a corporation is first going public, making an acquisition, or raising capital. The main reasons that corporations issue restricted stock, rather than tradable stock, are to avoid dilution of their stock price with an excessive number of shares available for sale at any one time and to avoid the costs of registering the securities with the SEC.

The registration exemption on restricted stocks is granted under Section 4(2) of the 1933 Securities Act. The intent of Section 4(2) is to provide "small" corporations with the ability to raise capital without incurring the costs of a public offering. Regulation D, a safe harbor regulation, which became effective in 1982, falls under section 4(2) of the code and provides uniformity in federal and state securities laws regarding private placements of securities. Securities bought under Regulation D are subject to restrictions, the most important being that the securities cannot be resold without either registration under the Act, or an exemption.[15] The exemptions for these securities are granted under Rule 144.

> *Rule 144 allows the limited resale of unregistered securities after a minimum holding period of two years. Resale is limited to the higher of 1 percent of outstanding stock or average weekly volume over a 4 week period prior to the sale, during any three month period. There is no quantity limitation after a four year holding period.[16]*

Therefore, a holder of restricted stock must either register their securities with the SEC or qualify for a 144 exemption, in order to sell their stock on the public market. A holder of restricted stock can, however, trade the stock in a private transaction. Historically when traded privately, the restricted stock transaction was usually required to be registered with the SEC. However, in 1990, the SEC adopted Rule 144a which relaxed the SEC filing restrictions on private

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14 From "Discounts Involved in Purchases of Common Stock (1966 - 1969)," Institutional Investor Study Report of the Securities and Exchange Commission. H.R. Doc. No. 64, Part 5, 92d Cong., 1st Sess. 1971, pp. 2444-2456.

15 Kasim L. Alli, Ph.D. and Donald J. Thompson, Ph.D. "The Value of the Resale Limitation on Restricted Stock: An Option Theory Approach," American Society of Appraisers: Valuation, March 1991, pp. 22-23.

16 Ibid.

transactions. The rule allows qualified institutional investors to trade unregistered securities among themselves without filing registration statements.[17] *Effective April 1997, the two year holding period was reduced to one year.*

The overall effect of these regulations on restricted stock, is that when issued, the corporation is not required to disclose a price and, on some occasions, even when traded, the value of restricted securities is still not a matter of public record. Table 13 is a summary of many of the more familiar studies regarding restricted stock.

TABLE 13
RESTRICTED STOCK STUDIES

Study	*Years Covered in Study*	*Average Discount (%)*
SEC Overall Average[a]	*1966-1969*	*25.8*
SEC Non-Reporting OTC Companies[a]	*1966-1969*	*32.6*
Gelman[b]	*1968-1970*	*33.0*
Trout[c]	*1968-1972*	*33.5*[i]
Moroney[d]	[h]	*35.6*
Maher[e]	*1969-1973*	*35.4*
Standard Research Consultants[f]	*1978-1982*	*45.0*[i]
Willamette Management Associates[g]	*1981-1984*	*31.2*[i]
Silber Study[j]	*1981-1988*	*33.8*
FMV Study[k]	*1979 - April 1992*	*23.0*
FMV Restricted Stock Study[l]	*1980 -1997*	*22.3*
Management Planning, Inc.[m]	*1980-1996*	*27.1*
Bruce Johnson[n]	*1991-1995*	*20.0*
Columbia Financial Advisors[o]	*1996-February 1997*	*21.0*
Columbia Financial Advisors[o]	*May 1997-1998*	*13.0*

Notes:

[a] *From "Discounts Involved in Purchases of Common Stock (1966-1969)," Institutional Investor Study Report of the Securities and Exchange Commission. H.R. Doc. No. 64, Part 5, 92d Cong., 1st Sess. 1971, pp. 2444-2456.*

[b] *From Milton Gelman, "An Economist-Financial Analyst's Approach to Valuing Stock of a Closely-held Company," Journal of Taxation, June 1972, pp. 353-354.*

[c] *From Robert R. Trout, "Estimation of the Discount Associated with the Transfer of Restricted Securities," Taxes, June 1977, pp. 381-385.*

[d] *From Robert E. Moroney, "Most Courts Overvalue Closely-held Stock," Taxes, March 1973, pp. 144-154.*

[e] *From J. Michael Maher, "Discounts for Lack of Marketability for Closely-Held Business Interests," Taxes, September 1976, pp. 562-571.*

[f] *From "Revenue Ruling 77-287 Revisited," SRC Quarterly Reports, Spring 1983, pp. 1-3.*

[g] *From Willamette Management Associates study (unpublished).*

[h] *Although the years covered in this study are likely to be 1969-1972, no specific years were given in the published account.*

[i] *Median discounts.*

[j] *From William L. Silber, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," Financial Analysts Journal, July-August 1991, pp. 60-64.*

[k] *Lance S. Hall and Timothy C. Polacek, "Strategies for Obtaining the Largest Discount," Estate Planning, January/February 1994, pp. 38-44. In spite of the long time period covered, this study analyzed only a little over 100 transactions involving companies that were generally not the smallest capitalization companies. It supported the findings of the SEC Institutional Investor Study in finding that the discount for lack of marketability was higher for smaller capitalization companies.*

[l] *Espen Robak and Lance S. Hall, "Bringing Sanity to Marketability Discounts: A New Data Source," Valuation Strategies, July/August 2001, pp. 6-13, 45-46.*

[m] *Robert P. Oliver and Roy H. Meyers, "Discounts Seen in Private Placements of Restricted Stock: The*

17 Richard A. Brealey and Steward C. Myers, "How Corporations Issue Securities," Chapter 14, Principles of Corporate Finance, 5th Edition, McGraw-Hill, Inc. 1996, pp. 399-401.

Management Planning, Inc., Long-Term Study (1980-1996)" published in Chapter 5 of Robert F. Reilly and Robert P. Schweihs, eds. The Handbook of Advanced Business Valuation (New York: McGraw-Hill, 2000).

n *Bruce Johnson, "Restricted Stock Discounts, 1991-1995," Shannon Pratt's Business Valuation Update, March 1999, pp. 1-3. Also, "Quantitative Support for Discounts for Lack of Marketability," Business Valuation Review, December 1999, pp. 152-155.*

o *Kathryn Aschwald, "Restricted Stock Discounts Decline as a Result of 1-Year Holding Period," Shannon Pratt's Business Valuation Update, May 2000, pp. 1-5. This study focuses on the change in discounts as a result of the holding period reduction from two years to one year.*

Source: Guide to Business Valuations, Practitioners Publishing Co., Fort Worth, Texas, 2002.

THE NEXT SECTION OF THE REPORT DISCUSES THE VARIOUS STUDIES AND HAS BEEN ELIMINATED TO SAVE SPACE.

REVENUE RULING 77-287

In 1977, in Revenue Ruling 77-287, the Internal Revenue Service specifically recognized the relevance of the data on discounts for restricted stocks. The purpose of the ruling was "to provide information and guidance to taxpayers, Internal Revenue Service personnel and others concerned with the valuation, for Federal tax purposes, of securities that cannot be immediately resold because they are restricted from resale pursuant to Federal security laws."[18] The ruling specifically acknowledges the conclusions of the SEC Institutional Investor Study and the values of restricted securities purchased by investment companies as part of the "relevant facts and circumstances that bear upon the worth of restricted stock."

All of the studies concerning restricted stock generally deal with minority blocks of stock in public companies. Therefore, the restricted stock studies may be a useful guide in assessing a discount for lack of marketability to a minority interest. However, a control value may also need to reflect a DLOM, although it probably would be smaller than a DLOM attributable to minority shares. Since a minority interest is more difficult to sell than a controlling interest, the DLOM is usually larger for minority interests. The average DLOM ranges between 25 and 45 percent based on the studies discussed previously. Larger discounts may be appropriate if the starting point is a marketable, minority interest value based on public guideline company methods.

INITIAL PUBLIC OFFERING STUDIES

Another manner in which the business appraisal community and users of its services determines discounts for lack of marketability is with the use of closely-held companies that underwent an initial public offering (IPO) of its stock. In these instances, the value of the closely-held stock is measured before and after the company went public.

TO SAVE SPACE, THE DISCUSSION ABOUT THE STUDIES HAS BEEN ELIMINATED

OTHER CONSIDERATIONS

Another consideration in determining a discount for lack of marketability is the cost of flotation of a public offering. These costs are generally significant and will frequently include payments to attorneys, accountants, and investment bankers. The costs associated with smaller offerings can be as much as 25 to 30 percent of a small company's equity.

CONCLUSION

As far back as 1977, through Revenue Ruling 77-287, the Internal Revenue Service recognized the effectiveness of restricted stock study data in providing useful information for the quantification of discounts for lack of marketability. The Baird and Willamette studies of transactions in closely-held stocks did not exist at that time, but the IRS and the courts have been receptive to using this data to assist in quantifying discounts for lack of marketability.

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18 Revenue Ruling 77-287 (1977-2 C.B. 319), Section I.

The IPO studies are proof that larger discounts can be justified than those quoted from the restricted stock studies. One of the best explanations of why a DLOM varies from case to case was included in an article published by Robert E. Moroney entitled "Why 25% Discount for Nonmarketability in One Valuation, 100% in Another?"[19] In Moroney's article, he points out 11 different factors that should be considered in the application of a DLOM. These factors are as follows:

1. *High dividend yield: Companies that pay dividends tend to be more marketable than companies that do not.*
2. *Bright growth prospects: Companies that have bright growth prospects are easier to sell than companies that do not. This makes them more marketable.*
3. *Swing value: If a block of stock has swing value, it may be more marketable than the typical small block of stock. This swing value could include a premium. This can be emphasized where a 2 percent interest exists with two 49 percent interests. The 2 percent interest can be worth quite a bit to either 49 percent interest if it will give that interest control of the company.*
4. *Restrictions on transfer: Restrictions on transfer make the stock less marketable due to the difficulty in selling them.*
5. *Buy-sell agreements: Buy-sell agreements can go either way. The agreement can create a market for the stock, making it more marketable, or the agreement can restrict the sale making it less marketable.*
6. *Stock's quality grade: The better the quality of the stock, the more marketable it will be. This can be evidenced by comparing the subject company to others for supporting strengths and weaknesses.*
7. *Controlling shareholder's honesty: The integrity of the controlling shareholder can make a big difference regarding the ability to sell a partial interest in a company. If the controlling shareholder tends to deal with the other shareholders honestly, the other interests in that company tend to be more marketable.*
8. *Controlling shareholder's friendliness: Similar to the shareholder's honesty, the manner in which he or she deals with others can make the stock more marketable.*
9. *Prospects for the corporation: If a corporation has good prospects for the future, it will generally be more marketable.*
10. *Prospects for the industry: A company that is in an industry with good prospects will also generally be more marketable.*
11. *Mood of the investing public: When the investing public is bullish, they are more readily willing to make an investment. This can increase the marketability.*

In this assignment, we are appraising a minority interest that has no control in Jones. Most of the marketability studies discussed have supported discounts of 25 to 45 percent. These studies relate to minority interests in companies that are either public, with restrictions under Rule 144, or private, but about to go public. Therefore, an argument can easily be made to support a higher discount for an interest in a closely-held limited liability company that is not going public.

To derive a DLOM for Jones, we considered the following factors:

Dividend Yield: The Agreement leaves the decision regarding the payment of distributions in the control of the Management Committee. At the current time, The LLC has earnings; an approximate 4 percent return on its net asset value. However, the Management Committee is currently reinvesting all of the earnings in additional assets. Although this could possibly increase the value of the portfolio, it does not provide a dividend yield to an investor.
Growth Prospects: The stock market was strengthening at the valuation date. However, due to rising interest rates, the value of the bonds will decrease. With bonds making up the vast majority of the portfolio, the growth prospects for Jones are not considered to be strong.
Degree of Control: All of The LLC's operations are controlled by the Management Committee. In addition, the interest being appraised is an assignee interest. The interest being appraised has no control.
Restrictions on Transfer: The restrictions on transfer of membership interests have been reviewed earlier. These provisions have the effect of limiting the marketplace for these interests.
Buy-Sell Agreements: There are no buy-sell agreements with respect to this interest.
Stock Quality Grade: If this interest was publicly traded, its portfolio would be considered of average quality due to its diversification.
Controlling Shareholder Honesty: This is not considered to be an issue in this appraisal.
Prospects for The Company: The LLC is expected to exist into perpetuity and its assets are expected to grow, although the rate of growth is unknown and could be cyclical. Therefore, if management decides to begin selling assets, the timing of the sales could be crucial.

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19 *Taxes, May 1977.*

<u>Prospects for the Industry</u>: The market where the various assets trade are relatively steady, although uncertain.
<u>Mood of the Investing Public</u>: According to reports, the investing public expects the U.S. and global economies to continue to expand. This expansion will help increase bond issuance volume in some sectors, while the anticipation of higher interest rates will hurt volume in other parts of the market; the municipal bond market being one of them.

In addition to the factors above, a buyer of an interest in Jones would obtain an assignee interest, rather than a full membership interest. This might make it more difficult for a willing seller to find a willing buyer.

The seller, on the other hand, might reduce his asking price in order to obtain immediate liquidity. The LLC does not have a fixed termination or liquidation date, and has not made distributions. Although a member can transfer his or her interest, a member cannot require The LLC to purchase his or her interest. This results in ownership of an asset that provides no current liquidity and no definitive future liquidity. Therefore, a member might negotiate a lower selling price to provide him or herself with liquidity.

Based on the facts and circumstances, a DLOM of 30 percent was deemed appropriate for this assignment.

Example 5 – Premiums and Discounts – Real Estate

Note: Only those sections that are different from the section shown above are included here

<u>PREMIUMS AND DISCOUNTS</u>

CONTROL PREMIUM / LACK OF CONTROL DISCOUNT

The net asset value of The LLC was used to determine the control value of the entire entity. However, to realize this value, an investor would need to be able to gain access to, and liquidate, the underlying assets of The LLC. If members were afforded this level of control, member interests might well be worth a pro rata share of The LLC's net asset value. However, this is not the case in this valuation.

The Agreement specifically vests all decision making solely in the manager. The basis for lack of control adjustments for limited liability company member interests arise from a range of factors, which include:

- *Members generally cannot control the day-to-day management or operation of The LLC.*
- *Members generally cannot control the amount or timing of income distributions to other members.*
- *Members do not have specific claims on the underlying assets of The LLC, and they usually cannot compel the dissolution of a limited liability company or the liquidation of its underlying assets. In this case, The LLC has a termination date of December 31, 2026, slightly more than 20 years from the valuation date.*
- *It is usually very difficult for members to remove management.*
- *It is usually very difficult for members to amend a limited liability company agreement.*

The net asset value method develops a freely traded, control value of The LLC's net assets of $4,870,962 as of August 28, 2006, and therefore does not provide a meaningful indication of value for a minority interest in The LLC. A discount for lack of control is appropriate here because an interest in The LLC represents an indirect ownership interest in the underlying assets held by The LLC.

One approach to determining an appropriate discount for lack of control is to compare the interest under appraisal to published control premium studies. This can be accomplished using publications such as Mergerstat Review, cited previously.

Another method of estimating the appropriate discount for lack of control for RealCo is to attempt to draw a parallel between The LLC's portfolio and closed-end funds (CEFs). Hundreds of closed-end funds are available for numerous specialized investment options. Prices paid for publicly-traded shares in a CEF represent minority interests in fully marketable securities. Therefore, if the net asset value of a CEF can be determined and compared with the freely-traded price of the fund, it can be determined when and under what conditions the market affords a discount (or premium) to the net asset value of a minority interest.

Unlike open-end mutual funds, CEFs issue a fixed number of shares. Therefore, investors must buy shares from other investors, not the fund itself. These CEFs mirror the motivations of buyers and sellers, and offer empirical evidence for determination of the appropriate magnitude of the minority interest discount to be applied.

We located closed-end funds in the August 28, 2006 issue of Barron's. Although the investments in these funds are not identical to the investments owned by RealCo, and the CEFs are considerably larger and more diversified than RealCo, the discounts from net asset value can serve as a proxy for a discount for lack of control for RealCo as these funds are in a similar industry as RealCo, and the investors in these funds have similar reductions regarding access to the funds as investors in The LLC have.

The data located in Barrons is as of August 25, 2006, and is presented in Table 5:

TABLE 5
REAL ESTATE FUNDS

	NAV	Market Price	Prem/Disc	52 week Market Return
AEW Real Est Inc (RIF)	24.03	20.55	-14.5	22.1
AIM Sel Real Est (RRE)	18.94	18.03	-4.8	34.0
CohenStrsAdvIncRlty (RLF)	25.35	24.68	-2.6	32.6
CohenStrsPremIncReal (RPF)	26.29	24.34	-7.4	33.5
Cohen&SteersQualInc (RQI)	24.56	23.08	-6.0	31.8
CohenStrsREITPref (RNP)	30.72	28.78	-6.3	25.0
CohenStrsREITUtls (RTU)	23.49	20.04	-14.7	15.1
ChnStrWldWRltyInc (RWF)	21.87	22.51	2.9	22.2
Div Cap Rlty Inc All (DCA)	14.50	13.88	-4.3	9.8
DWS RREEF Real Estate (SRQ)	27.25	23.45	-13.9	25.5
DWSRREEF (SRO)	20.80	17.76	-14.6	24.0
ING ClrnGlbRlEst (IGR)-a	20.70	19.40	-6.3	40.8
ING ClrnRlEst (IIA)-a	20.25	18.07	-10.8	30.9
NubrgrRlEstSec (NRO)	19.36	16.43	-15.1	25.7
NeubrgrBrmREI (NRL)	29.47	25.62	-13.1	27.3
Neuberger Realty Inc (NRI)	25.17	21.38	-15.1	26.9
Nuv Real Est (JRS)	24.48	24.93	1.8	40.0
Real Estate Inc (RIT)	23.39	20.15	-13.9	18.7
ReavesUtilityIncome (UTG)	24.39	21.20	-13.1	9.3
RMR FIRE Fund (RFR)	22.53	20.30	-9.9	7.5
RMR HospRlEstFd (RHR)	23.93	20.70	-13.5	15.9
RMRRealEstate Fd (RMR)	17.71	15.30	-13.6	19.5
Mean			**-9.5**	
Median			**-12.0**	

Source: "Closed-End Funds" (Barrons, August 28, 2006): M52.

Another source of discount information located is real estate limited partnerships that trade in the secondary market.

The real estate partnerships analyzed were compiled by Partnership Profiles, Inc. We started our search by looking for those partnerships that were classified as retail and had not announced liquidation plans. We did not utilize partnerships that had announced plans for liquidation because RealCo is planning on a long-term existence and therefore would not be similar to partnerships that had announced their intentions to liquidate. Ten partnerships were located that matched this criteria. Of these, three did not include pricing information. The details of the remaining partnerships located appear in Table 6.

TABLE 6

Partnership Name	*Number of Properties*	*Price to NAV*	*Total Nav*	*Revenue*	*Types of Properties*	*Borr/NAV*	*Yield/NAV*	*Yield/Price*
Angeles Income Properties II	*5*	*0.695 : 1*	*$ 15,796,805*	*$ 5,220,000*	*MF, R*	*146.20%*	*0.00%*	*0.00%*
Angeles Opportunity Properties	*5*	*0.676 : 1*	*1,838,900*	*1,593,000*	*C, MF, R*	*260.20%*	*0.00%*	*0.00%*
Corporate Property Associates 12	*40*	*0.853 : 1*	*407,789,465*	*50,642,000*	*C, R*	*46.20%*	*6.20%*	*7.30%*
Rancon Realty Fund IV	*12*	*0.711 : 1*	*58,555,492*	*7,544,000*	*C, R, Land*	*41.00%*	*3.00%*	*4.30%*
Rancon Realty Fund V	*9*	*0.870 : 1*	*69,719,100*	*10,415,000*	*C, R, Land*	*54.10%*	*3.20%*	*3.70%*
Resources Accrued Mortgage Investors 2	*1*	*0.676 : 1*	*25,763,695*	*3,090,000*	*R*	*0.00%*	*0.00%*	*0.00%*
Wells Real Estate Fund VIII-A	*7*	*0.806 : 1*	*20,739,333*	*1,064,000*	*C, R*	*0.00%*	*5.20%*	*6.40%*

MF = Multi-Family.
C = Commercial (Office Buildings, Industrial Warehouses, Research and Development Facilities, Business Parks).
R = Retail.
Land = Undeveloped Land.

Based on the data in Table 6, the average and median price to net asset values were 75.5 and 71.1 percent, respectively. This equates to average and median discounts from net asset value of 24.5 and 28.9 percent, respectively.

Of the partnerships reporting pricing information, most of them have debt, and four of them pay distributions.

Since many of the partnerships are categorized as both retail and commercial, the valuation analyst ran a search for commercial properties. The search located 20 partnerships; five of them did not include pricing information, and one reported negative revenues. These were eliminated from our analysis. The remaining partnership data is reflected in Table 7.

TABLE 7

Partnership Name	*Number of Properties*	*Price to NAV*	*Total Nav*	*Revenue*	*Types of Properties*	*Borr/NAV*	*Yield/NA*	*Yield/Price*
Angeles Opportunity Properties	5	0.676 : 1	$ 1,838,900	$ 1,593,000	C,MF,R	260.20%	0.00%	0.00%
Consolidated Capital Institutional Properties 1	13	0.887 : 1	67,675,300	23,117,000	C, MF	95.70%	0.00%	0.00%
Consolidated Capital Institutional Properties 3	8	0.514 : 1	27,578,376	12,410,000	C,MF	192.90%	0.00%	0.00%
Corporate Property Associates 12	40	0.853 : 1	407,789,465	50,642,000	C,R	46.20%	6.20%	7.30%
Corporate Realty Income Fund I	8	0.476 : 1	60,147,985	8,133,000	C	50.70%	0.00%	0.00%
HCW Pension Real Estate Fund LP	2	0.541 : 1	8,853,672	2,286,000	C,MF	54.20%	NSD	NSD
Rancon Realty Fund IV	12	0.711 : 1	58,555,492	7,544,000	C,R,Land	41.00%	3.00%	4.30%
Rancon Realty Fund V	9	0.870 : 1	69,719,100	10,415,000	C,R,Land	54.10%	3.20%	3.70%
Wells Real Estate Fund IX-A	9	0.808 : 1	19,834,116	1,079,000	C	0.00%	6.00%	7.40%
Wells Real Estate Fund VIII-A	7	0.806 : 1	20,739,333	1,064,000	C,R	0.00%	5.20%	6.40%
Wells Real Estate Fund X - B	7	0.811 : 1	1,562,945	592,000	C	0.00%	0.00%	0.00%
Wells Real Estate Fund X-A	7	0.803 : 1	11,131,903	592,000	C	0.00%	4.80%	6.00%
Wells Real Estate Fund XII-CP	7	0.874 : 1	18,392,275	1,276,000	C	0.00%	6.50%	7.50%
Wells Real Estate Investment Trust	114	0.877 : 1	4,045,312,924	593,963,000	C	29.70%	6.70%	7.70%

C = Commercial (Office Buildings, Industrial Warehouses, Research and Development Facilities, Business Parks).
R = Retail.
Land – Undeveloped Land.
MF = Multi Family.

The average and median price to net asset values are 75.2 and 80.7 percent, respectively. This equates to average and median discounts of 24.8 and 19.3 percent, respectively.

Partnership Profiles has been reporting data regarding sales of units of real estate partnerships in the secondary market since 1990. A summary of price-to-value discounts reported in its annual studies is as follows:[20]

1993	*46%*
1994	*48%*
1995	*41%*
1996	*38%*
1997	*30%*
1998	*29%*
1999	*27%*
2000	*25%*
2001	*28%*
2002	*22%*
2003	*21%*
2004	*23%*
2005	*28%*
2006	*29%*

This data includes all categories of partnerships. In discussing the discounts, Partnership Profiles states the following:

> *The overall decline in price-to-value discounts since 1994 is primarily the result of secondary market buyers shortening the holding period expectations in their pricing models. In 1993 and 1994, for instance, when average price-to-value discounts were a hefty 46% and 48%, respectively, secondary market buyers of real estate partnership interests anticipated it would be many years before these programs would liquidate their assets, at which time the price-to-value discount and any subsequent increase in value of the program's real estate would be realized in the form of a capital gain. This long-term liquidation scenario was generally eight to ten years, considering there was no reason at that time - with real estate in the doldrums - to believe that these programs would be liquidated any sooner. Indeed, about the only partnership liquidations occurring in 1993 and 1994 were forced liquidations by debt-laden partnerships unable to hang on to their properties until the real estate sector bounced back.*
>
> *This long-term liquidation scenario began to change, however, in 1995 and 1996 when real estate finally turned the corner which led some of the more prominent sponsors of real estate limited partnerships to begin selling properties out of their programs, much to the delight of secondary market investors who had acquired interests in these partnerships at steep discounts. When the real estate recovery fully kicked in during 1997 and 1998, more sponsors made the move to begin selling real estate out of their partnerships.*[21]

The article goes on to say:

> *The effect of all this is that, what had once been an eight–ten year anticipated holding period for real estate partnerships trading in the secondary market has now become more like a two-to-five year outlook. Given the greater likelihood of reaping capital gains from partnership liquidations in the relative near term - as opposed to eight to ten years down the road - buyers began paying higher*

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20 "Executive Summary: 2006 Survey of Partnership Re-Sale Discounts, (Partnership Profiles, Inc. 2006): 2.

21 Ibid.

prices for units of real estate partnerships relative to net asset values. This has caused average discounts to decline from a high of 48% in 1994 to roughly half that amount in today's secondary market.[22]

However, an investment in RealCo is much longer because The Agreement states that The LLC cannot be dissolved until December 31, 2026 without the vote of a majority of the members and the approval of the mortgage holder. It is unlikely that the mortgage holder would permit the dissolution of The LLC until the mortgage is paid in full. Currently, there is just under $2 million owed, and principal is only being reduced at a rate of about $20,000 per year. This indicates that it will be some time until the mortgage has been discharged.

In summarizing its most recent results, Partnership Profiles states:

> *Consistent with previous price-to-value discount surveys published by PPI, the programs in this year's survey were grouped into categories based upon the key attributes that impact how secondary market buyers price these interests. While the overall average discount for all of the programs included in this survey is 29%, price-to-value discounts can vary significantly from one program to the next depending primarily upon debt structure and the ability to pay cash distributions from operating cash flow.*
>
> *The results of this new price-to-value discount survey are entirely consistent with previous surveys in that the two most important factors considered by secondary market buyers when pricing units of real estate programs that have not announced a definitive liquidation plan continue to be (i) the program's ability to pay operating cash distributions and recent history of actually paying such distributions and (ii) the degree of debt financing, if any, utilized by the program.*
>
> *The emphasis buyers place on regular operating cash distributions and financing structure is evidenced by the fact that units of debt-free partnerships paying high distribution yields trade in the secondary market at the lowest price-to-value discounts, while non-distributing partnerships owning improved real estate laden with debt typically trade at the highest discounts. While the type of real estate owned by a program might have some bearing on how its units are priced in the secondary market, this factor is not nearly as important to buyers as the program's ability to pay operating cash distributions and the amount of debt, if any, encumbering its properties.*[23]

We utilized the data classified as commercial for the analysis, as it included all of the partnerships in the retail category, as well as several others. A larger dataset is generally more statistically valid.

Of the 14 partnerships, only nine of them had debt in their capital structure. Of those, only four of them pay distributions, and the dividend yields range from 4.30 to 7.70 percent.

The appraiser analyzed the median discounts[24] *for various categories. These are summarized below:*

Overall discount (14 partnerships)	*19.3%*
Partnerships with debt (9 partnerships)	*28.9%*
Partnerships with distributions (8 partnerships)	*17.0%*
Partnerships with both (4 partnerships)	*13.9%*

22 Ibid.: 3.

Clearly, the last category is the most relevant, but with only four data points, the results are not statistically valid. The datasets with only nine and eight partnerships are also relatively sparse. Therefore, the valuation analyst started with the discount for the category as a whole.

One of the problems that arises in utilizing this data is what the price to value discount actually represents. Partnership Profiles describes the discounts in relationship to the data as follows:

> *Valuation professionals attribute the fact that minority interests in non-listed real estate partnerships are priced at discounts from net asset values in the secondary market to two factors, both of which are discussed below:*
>
> *Discount for Marketability*
> *While the partnership secondary market does provide a market for minority interests in otherwise non-traded limited partnerships this market does not offer the liquidity of say, the New York Stock Exchange where investors can convert their securities into cash in a matter of days. As previously noted a spokesman for APB, the most active secondary market firm in terms of trading volume, recently indicated that the typical seller receives payment for their units in approximately 45 days. (This comment was made by Neal Buckley, Sales Manager of APB, at a May 2006 conference on non-listed REITs in New York City sponsored by Information Management Network.) It is important to mention, however, that this time-frame can vary significantly depending upon how often the partnership recognizes change of ownership transfers and the timing of the sale relative to that interval.*
>
> *When it comes to the marketability of the partnership interests included in the "Partnership Re-Sale Discount Studies" published annually by PPI, it is not a matter of whether buyers can be found for the units of a particular partnership, assuming the units are not overpriced. As stated above, more than $1.2 billion in sales transactions occurred in the secondary market from 1994 through 2005 which says a lot about the marketability of the interests that change hands in this market. With plenty of secondary market buyers standing ready to purchase these interests, the real issue of liquidity is the amount of time it takes for the seller to receive payment for their units which is a function of the mechanics of this market and the transfer cycle of the particular partnership or REIT.*
>
> *Discount for Lack of Control*
> *The other factor that accounts for why partnership interests trade in the secondary market at discounts is that these are noncontrolling, minority interests in every sense. This means that the owner of the interest has no control or influence over the affairs of the partnership. Indeed, the prospectus for every public limited partnership ever formed contains a statement that says something to the effect that 'all decisions with respect to the management of the partnership will be made exclusively by the general partner.' As would be expected, secondary market buyers of minority interests in limited partnerships are unwilling to pay 'full value' for an interest in a partnership over which they have no management influence or control. Valuation analysts refer to this as a discount for lack of control.*
>
> *While the discount for marketability component of the overall price-to-value discount is a relatively straight-forward concept since it addresses the liquidity of non-publicly-traded partnership interests relative to other investments such as exchange-listed securities, the discount for lack of control component reflects the fact that the owner of a non-controlling interest in a partnership does not have the ability to:*
>
> *(1) manage, refinance or liquidate the assets held by the partnership;*
> *(2) distribute income and/or capital gains generated by the partnership's assets; or*
> *(3) utilize the partnership's assets for collateral purposes.*
>
> *The discount for lack of control also reflects the potential pitfalls associated with owning a non-controlling, minority interest in a limited partnership, whether public or private. Some of the issues that are applicable to limited partnerships include: (i) general partner entrenchment; (ii) no minimum cash distribution requirements; and (iii) the inability to control or influence the timing of the liquidation of a partnership which can leave investors 'trapped' in this investment for many years.*
>
> *Anyone familiar with limited partnerships realizes that there are unique risks associated with owning a noncontrolling interest in a partnership - whether public or private - that result in lack of control*

discounts being factored in by buyers of these interests. The theory that partnership units trade in the secondary market at significant price-to-value discounts because the sellers of such interests are 'distressed' is incorrect. While it may be that a particular seller is 'distressed' due to some adverse personal situation, the multiple bidders offering to buy the units would have no way of knowing this since secondary market transactions are brokered through third-parties in arms-length transactions where buyers and sellers have no direct contact. Even if in the very unlikely event all of the prospective buyers were somehow aware that a seller was 'distressed,' the partnership units would still go to the highest bidder who would price the units irrespective of why they were being sold. This is really no different than purchasing shares of a company listed on the New York Stock Exchange in that (i) seller's personal reasons for selling are not only unknown but also irrelevant to the buyer and (ii) the identify of the seller is not even known.

Appraisers using data from this survey for valuation purposes must make absolutely sure that the family limited partnership (FLP) or other interest being valued is indeed a noncontrolling interest in every respect. This requires a thorough examination of the governing documents of the FLP or other entity that is the issuer of the interest being valued. If it cannot be clearly established by these governing documents that the owner of the interest being valued has no ability to control the management of the entity's assets, or if there are no formal governing documents that even address this issue, it may be that the data reported in this survey should not be used since these price-to-value discount figures primarily reflect lack of control considerations, as discussed further below.

Discount for Marketability vs. Lack of Control
For appraisers using data from this survey to value what is truly a noncontrolling interest in an entity owning real estate, the real issue is not whether discounts are valid when valuing such an interest, but how much of the price-to-value discounts applicable to secondary market trading in limited partnerships reflects lack of marketability versus lack of control considerations. Indeed, the question most often posed by business valuation professionals, real estate appraisers and CPAs when using data from the annual discount surveys published by PPI to determine discounts for minority interests in real estate assets is how much of the overall price-to-value discount reflects lack of marketability versus lack of control issues.

Although it is not possible to precisely quantify the amount of discount attributable to marketability versus lack of control considerations, it is the opinion of PPI, along with many appraisers, that most of the overall discount is due to lack of control issues. While the partnership secondary market is certainly not a recognized securities exchange, it is a market where there are usually multiple bidders who stand ready to purchase the units of virtually any publicly-registered partnership that has value. As previously discussed, it is typically not a matter of whether the units of a partnership can be sold, but a matter of how long it takes to get the sale proceeds into the hands of the seller.

PPI has examined several methods to gauge the extent to which the total price-to-value discounts observed in the partnership secondary market reflect marketability issues. One of these analyses considered the amount of time it takes to sell a publicly-held limited partnership or REIT interest and pay the net proceeds to the seller. (As previously noted, APB has stated that the average amount of time required to actually disburse funds to a seller in this market is approximately 45 days from the date of sale.) Simply using the time value of money, this analysis suggests that a relatively small portion of the overall discount is due to marketability. Specifically, the estimated portion of the discount for marketability was less than 10% of the overall discount.

While it appears that most of the overall price-to-value discounts inherent in the pricing of partnership interests trading in the secondary market is due to lack of control, it is difficult, it not impossible, to allocate with any precision the lack of control versus the marketability component of the total discount. Some valuation professionals believe that the issues of control and marketability are so interrelated that it is simply not possible to ascertain exactly how much of the total discount is attributable to lack of control versus marketability.[25]

25 Ibid.: 10-12.

As previously discussed, in determining a discount for The LLC, we began with the commercial properties' median discount of 19.3 percent. All of these partnerships are larger than RealCo and more diversified, which would tend to increase the discount. However, there is no statistically valid way to support an additional discount.

According to Partnership Profiles, most of this discount is reflective of a lack of control, however, it believes that approximately 10 percent of the discount is associated with a lack of liquidity (marketability). However, the discount rate derived in the previous section is derived from the same data, and therefore reflects similar lack of control and liquidity characteristics. Therefore, a discount of 19 percent for lack of control is derived from this data.

Based on our analysis, the applicable discount utilizing CEFs was approximately 12 percent, while the discount using the Partnership Profiles' data is 19 percent.

We chose the data from Partnership Profiles as being more appropriate for several reasons. The underlying assets in the CEFs are marketable securities; these assets can be sold and converted to cash in three days. In addition, they are very diversified funds; for most of them, their largest holding is only 2 to 3 percent of net asset value.

The real estate partnerships on the other hand are not as diversified or liquid as the CEFs. In addition, their underlying assets are also commercial properties; many of them are retail properties.

Based on the foregoing, a discount for lack of control of 19 percent is deemed applicable for this valuation.

DISCOUNT FOR LACK OF MARKETABILITY

CONCLUSION

In this assignment, we are appraising minority interests that have no control in RealCo. Most of the marketability studies discussed have supported discounts of 25 to 45 percent. These studies relate to minority interests in companies that are either public, with restrictions under Rule 144, or private, but about to go public. Therefore, an argument can easily be made to support a higher discount for an interest in a closely-held limited liability company that is not going public.

To derive a DLOM for RealCo, we considered the following factors:

Dividend Yield: The Agreement leaves the decision regarding the payment of distributions in the control of the manager. Since inception, distributions have been made that have been erratic. In 2005, total distributions were $155,193; a return on investment of approximately 3.2 percent, and to date in 2006, $145,000 has been distributed. Clearly, the members are receiving a dividend yield, which should continue, although that could depend on how long it takes to find a new tenant.
Growth Prospects: Since the inception of The LLC, the value of the real estate has grown. However, a minority owner cannot force the sale of this real estate to obtain any of this increase in value. Therefore, until such time that the real estate is sold and The LLC is liquidated, which might not be until at least 2026, the growth is irrelevant to the valuation subject. In addition, real estate markets have been known to decline in value as well, and any increase in value could be wiped out if the market turns.
Degree of Control: All of The LLC's operations are controlled by the manager. This has been reviewed previously. The interests being appraised have no control, unless they vote with other interests. There is nothing to indicate that this will happen. In addition, certain matters must also be approved by the mortgage holder, which further decreases the level of control.
Restrictions on Transfer: The restrictions on transfer of membership interests have been reviewed earlier. These provisions have the effect of limiting the marketplace for these interests.
Buy-Sell Agreements: There are no buy-sell agreements with respect to this interest.
Stock Quality Grade: If these interests were publicly traded, its portfolio would be considered to be of poor quality, as it is not diversified.
Controlling Shareholder Honesty: This is not considered to be an issue in this appraisal.
Prospects for The Company: The LLC is expected to exist until 2026 and its assets are expected to grow, although the rate of growth is unknown and could be cyclical. Therefore, if management decides to sell the real estate, the timing of the sales could be crucial. In addition, The LLC currently only has one tenant. This loss of the other one, or an inability to secure a new tenant quickly could create a cash flow problem, which would eliminate distributions for the minority owner.
Prospects for the Industry: After raising interest rates at every Federal Open Market Committee meeting from June 2004 through June 2006, interest rates were left unchanged at the August 8th meeting. Although there is a severe slowdown in

the residential real estate market, the commercial real estate market was strong at the valuation date, in particular in the Route 46 retail corridor.
Mood of the Investing Public: According to reports, the investing public appears to be more bullish regarding the outlook for the equities markets. Value Line believes that the equity markets will "work its way irregularly higher over the next six months."

In addition to the factors above, a buyer of an interest in RealCo would obtain an assignee interest, rather than a full membership interest. This might also make it more difficult for a willing seller to find a willing buyer.

The seller, on the other hand, might reduce his asking price in order to obtain immediate liquidity. The LLC does not have a fixed termination or liquidation date, and is making minimal distributions. Although a member can transfer his or her interest, a member cannot require The LLC to purchase his or her interest. This results in ownership of an investment that provides some current liquidity and unknown long-term liquidity. Therefore, a member might negotiate a lower selling price to provide him or herself with the ability to diversify and/or obtain liquidity.

The problem with the restricted stock studies is that these are based on operating companies traded on various stock exchanges, while RealCo is a small privately-held holding company. The question of relevance arises.

The studies are used as a proxy to measure the decrease in value of an investment due to the inability to sell it and have cash in three days. Although a member in The LLC can transfer an interest to a family member, or sell the interest to The LLC or another party, it takes time to find a buyer for an investment that is not actively traded, and pays minimal distributions.

The other exit strategy for an investor is to wait for dissolution of The LLC. However, there are currently no intentions to sell the properties, and The Agreement states that the termination date is not until 2026. Therefore, without large growth in the asset, an investor might have no return on the investment.

The studies described on the previous pages indicate that when an investor does not have access to an active, liquid market, his investment is worth less. An investor in RealCo does not have access to an active, liquid market and therefore, these studies are relevant, as they are objective information and data that measures the loss in value due to illiquidity.

However, marketability was also included as part of the discount for lack of control and rate of return. As previously discussed, Partnership Profiles does not know the exact differentiation in its data between lack of control and lack of marketability. However, it estimates it to be about 10 percent.

Based on the facts and circumstances, a DLOM of 30 percent was deemed appropriate for this assignment. This was reduced by 10 percent to reflect the liquidity discount already included in the rate of return and discount for lack of control. Therefore, the DLOM utilized is 27 percent.

Linda B. Trugman CPA/ABV, MCBA, ASA, MBA is the Vice President of Trugman Valuation Associates, Inc., a firm specializing in business valuation and litigation support services. Linda is a Certified Public Accountant licensed in the states of Florida and New Jersey. She is designated as Accredited in Business Valuation by the American Institute of CPAs, a Master Certified Business Appraiser by The Institute of Business Appraisers and an Accredited Senior Appraiser by The American Society of Appraisers. Linda is a member of the Qualifications Review Committee of The Institute of Business Appraisers, and formerly served on the International Board of Examiners of the American Society of Appraisers. She is currently serving as International Vice President of the American Society of Appraisers as well as Past Chair of the Business Valuation Committee of that organization. Linda formerly served as chair of the American Society of Appraisers Business Valuation Education Committee. Linda is a Fellow and former Governor of The Institute of Business Appraisers. She formerly served as Chair of the FICPA's Relations with the Florida Bar Committee, and on the steering committee of the Valuation, Litigation and Forensic Accounting Section of the FICPA. Linda currently serves as Secretary of the ASA Educational Foundation.

Linda is the former editor of the *ABV e-Alert*, a publication of the AICPA's Business Valuation Committee. She formerly served as editor of *Business Appraisal Practice*, the professional journal of The Institute of Business Appraisers., and served on the editorial board of *BV Q&A* published by Business Valuation Resources. Linda formerly served on the Business Valuation and the Business Valuation/Forensic and Litigation Services Executive Committees of the AICPA. She currently serves on the editorial board of *Financial Valuation and Litigation Expert* published by Valuation Products, LLC. In November 2009, Linda was inducted into the AICPA's Business Valuation Hall of Fame.

Linda teaches business valuation courses throughout the country for The Institute of Business Appraisers, the AICPA, various state societies of CPAs, and the American Society of Appraisers. She also lectures nationwide. She has served as faculty for the National Judicial College. Linda is a co-author of the first, second and third editions of *Financial Valuation Applications and Models,* published by Wiley Finance, has authored several self-study courses and has served as a technical reviewers on all four editions of the AICPA's *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses* as well as *The Lawyer's Business Valuation Handbook* authored by Shannon Pratt and published by the American Bar Association. She is also the editor of *BVR's Guide to Business Valuation Issues in Estate and Gift Tax*, 2010 edition.

Linda can be reached at linda@trugmanvaluation.com.