VALUATION Trends
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Astleford Has it All: Latest Tax Court Case on FLP Discounts, Data, and More

***Astleford v. Comm'r* (T.C. Memo 2008-128, May 5, 2008)**

In 1996, Mrs. Astleford formed the Astleford Family Limited Partnership (AFLP) to own and develop interests in real property, as well as facilitate gifts to her three adult children. She gave each of the children a 30% limited partnership (LP) interest, with no voting rights or capital requirements, while she remained a 10% general partner (GP), controlling the assets.

After initially funding AFLP with real property worth nearly $1 million, in 1997 Mrs. Astleford transferred 3,000 acres of land, including 1,187 acres of farmland that she held through a 50% GP interest in a development company. She gifted additional LP shares to her children to keep the 30-30-30 ownership configuration of AFLP, while staying on as 10% GP.

Upon audit of her 1996 and 1997 federal gift tax returns, the IRS found higher fair market values for the transferred properties and a higher net asset value (NAV) for the partnership. The IRS also decreased some of the discounts related to the gifted LP interests. Through various stipulations, the parties disputed only three issues at trial: 1) the fair market value of the farmland; 2) whether the 50% interest in the development company was as a GP or assignee interest; and 3) the applicable discounts.

'Market absorption' discount appropriate?

The taxpayer's real property appraiser considered the 1,187-acre farm property to be "extraordinarily large and unique," worth nearly $3.7 million. But its sale would flood the local market, he believed, reducing the price and requiring a market absorption discount. Assuming the property would sell over four years, appreciating 7% per year—and using a 25% discount rate to present-value the expected cash flows—the expert's final fair market value came to $1,817 per acre, or $2.16 million total.

The IRS appraiser examined 125 Minnesota properties, ultimately selecting two comparables to value the AFLP farmland at $3,500 per acre, or nearly $4.16 million total. The IRS expert omitted a market absorption discount; the development company originally purchased 1,187 acres in a single transaction, he said, so it could also sell the entire tract. In the alternative, he argued that a 25% present-value discount rate was excessive, when a 1997 Minnesota study showed farmers earning an average rate of return of 9.2%.

The Tax Court credited the IRS expert with a "unique knowledge" of the area and adopted his $3,500 per-acre value. But it also applied a market absorption discount based on the 9.2% rate of return, rounded up to 10% and applied over four years—which returned $2,786 per acre, or a total fair market value of $3.31 million.

Discounts for layered interests?

The taxpayer treated the transfer of the 50% GP interest to AFLP as an assignee interest, largely because the other 50% owner hadn't given consent. Under Minnesota law, because an assignee would only have rights to the profits—and no management control—the taxpayer's expert, as a preliminary matter, discounted the interest by 5%.

But the AFLP partnership resolution treated the transfer as one of all the taxpayer's rights and interests, the IRS pointed out. Further, as AFLP's sole GP, the taxpayer was essentially in the same management position whether she transferred a GP or assignee interest. The substance of the transfer should trump

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its form, the IRS argued. The court agreed, finding that the taxpayer funded AFLP with a 50% GP interest.

To determine a combined discount for lack of marketability and control for the 50% GP interest, the taxpayer's expert examined comparable data from sales of 17 registered real estate limited partnerships (RELPs), which established a range of 22% to 46%. But then, "without explaining further," according to the court, the expert applied a 40% combined discount to the 50% interest.

The IRS expert believed that because the 50% GP interest was "simply an asset of AFLP," the discounts he applied at the entity level obviated the application of discounts to the particular 50% interest. But in an interesting footnote, the court observed that in previous cases, the IRS (as well as the Tax Court) had applied layered discounts when a taxpayer held a minority interest in an entity that in turn owned a minority interest in another entity. "The 50-percent. . . interest constituted less than 16% of AFLP's [net asset value] and was only 1 of 15 real estate investments" that AFLP held at the time of the transfer, the court said. Lack of control and lack of marketability discounts at both the entity and shareholder levels were appropriate.

The court eliminated four of the RELP comparables selected by the taxpayer's expert because their data came from the wrong year. The remaining data showed trading discounts of 30% to 36%, and a 1997 sample of 130 RELPs ranged from 28.7% to 30%. The court thus concluded that a 30% combined discount applied to the 50% GP interest, valued at nearly $1.3 million.

LP discounts turn on selected comparables

In determining discounts for the gifts of LP interests, the taxpayer's expert examined four RELP comparables, with trading discounts that ranged from 40% to 47%. He ultimately applied a lack of control discount of 45% for the first gift year (1996) and 40% for the second (1997).

But his RELP comparables were "significantly more leveraged" than AFLP, according to the court. Moreover, because AFLP's cash distribution rate was significantly higher than the average RELP comparable's, the court found that the discount should have been even lower than the 38% observed average. The RELP comparables were "too dissimilar" to AFLP to warrant the expert's reliance, it ruled, and his combined discounts were "excessive."

By contrast, the IRS expert examined comparable sales of REITs (Real Estate Investment Trusts). The abundance of data was more reliable, he said, and any differences between REITs and the FLP interests could be minimized by "backing out" any liquidity premiums from the REIT sales price, resulting in lack of control discounts. REITs generally traded at a 7.79% liquidity premium over private real estate partnerships, the expert said. Combining this with the 1996/1997 trading data, he arrived at a lack of control discount for the LP interests of 7.14% in 1996 and 8.34% in 1997.

A good method misapplied

The court agreed with the IRS expert's method but held that, on their face, his discounts appeared unreasonably low. Moreover, other studies cited by the same expert suggested that the applicable liquidity premiums were nearly two times the levels he used.

A better method, the court said, was to look at the difference in average discounts observed in private placements of registered and unregistered stock, since a public market is available to the former but not the latter. This difference amounted to approximately 14%, according to a study cited by the IRS, resulting in a general liquidity premium of 16.27%. After backing out this premium from the median REIT trading data and making other adjustments, the court arrived at a lack of control discounts of 16.17% and 17.47% for the respective LP gifts.

As a final matter, the Tax Court compared the taxpayer's 15% marketability discount for the 1996 limited partnership gifts to the IRS's 21.23% and saw "no reason" not to adopt the higher discount. The court also adopted the parties' stipulated 22% marketability discount for the 1997 gifts and adjusted its findings accordingly.

Pros and Pitfalls of Retaining a Joint Appraisal Expert

There are many contexts in which attorneys and business owners might retain a joint valuation expert—during a merger or sale, for instance, a divorce, or a partnership dissolution. A joint appraiser can be a key player in a buy-sell scenario or a pre-litigation settlement. What follows are just a few of the ways to take advantage of a joint valuator—and a few potential problem areas to watch out for:

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- *Cost.* A joint expert will most likely reduce the costs associated with an appraisal in any setting, but especially in those cases when opposing experts are so far apart that the parties have to hire a third, independent valuator. This situation arises most often in buy-sell scenarios—but also in divorce cases when the court is confronted with such disparate evidence of value that it appoints a third, "independent" appraiser—at the parties' cost.
- *Full access to information.* When the parties retain a single valuation analyst, they will be more likely to provide greater access to information to support their respective opinions of the business and its future prospects. The valuator will in turn share all of the information with the parties, electronic communication as well as paper documentation, so that everyone is on the same "page," and greater objectivity is assured.
- *Experience.* When retaining a joint expert, look for seasoned, credentialed business appraisers who have worked on joint assignments in the past. Joint engagements do present unique challenges (discussed below), and familiarity with the process can be critical to a successful result.
- *Payment.* The parties should establish at the outset how to pay for the joint appraisal. If they can't agree on the typical 50/50 split, then they should address the issue along with any questions regarding scope of work.
- *Communication.* Preferably, the appraisers' engagement will establish rules about communication (as well as payment and scope of work). These rules will encompass communications to and among the parties and their attorneys as well as access to key business personnel, meetings and management interviews, etc.
- *Draft report.* The parties should also decide whether to review a draft report (for factual accuracy, comprehensive inputs, e.g.) before the valuator issues a final conclusion of value. The purpose is not to alter the preliminary opinion but to ensure that the valuator has considered all relevant facts and information.
- *Objective mediator.* In many cases, a joint expert can essentially become the "trier of fact" regarding valuation issues. As such, the valuator must inspire trust, demonstrating a high degree of integrity and independence by taking an even-handed, objective approach to the assignment.
- *Challenges.* Despite agreeing to hire a joint expert, the parties may have very different interests at stake and perspectives on value. The appraiser must be prepared to balance any opposing pressures from the parties—such as conflicting input, preconceived notions of value, unrealistic expectations—to arrive at a truly independent conclusion. When possible, it might behoove the valuator to seek independent data and sources of information to mitigate a party's opinion.
- *Educating the client.* In litigation settings, the standard of value will be set by statute and/or case law. Many buy-sell scenarios contain no definition of or provision for determining the standard of value, and the joint expert can help the clients and counsel understand the various standards, their application, and their implications as to value.
- *Encouraging trust.* While the parties—especially those to an adversarial proceeding—may not trust each other, once again, it is critical for the joint appraisal expert to inspire them with trust in the valuation process and its outcome. A joint expert must always maintain neutrality, in act if not in appearance, and disseminate information equally. The more even-handed the administration of a joint valuation assignment, the more successful the outcome—and satisfied the clients.

Does Solvency Determination Require Courts to Value Debts at Book Value?

***Waller v. Pidgeon*, 2008 WL 2338217 (U.S. Dist.) (June 5, 2008)**

An investor recouped nearly $5 million from a hedge fund over four years, receiving a final redemption payment of $650,000 on December 27, 2002. Four days later, the hedge fund (and three related entities) declared bankruptcy. The receiver sued the investor to recover the $650,000 payment as a fraudulent transfer, which required a showing (under Texas statute) that the fund was insolvent on the transfer date or became insolvent as a result.

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The parties stipulated to many facts, including the fair value of fund assets: $4.95 million as of December 2002. The book value of its liabilities was roughly $8.9 million, including $6.8 million that the fund owed to its related entities. Because the book value of the fund's liabilities exceeded the fair value of its assets, the receiver argued that the fund was insolvent as of the transfer date. But the investor claimed that a "fair valuation" required the court to deduct the related-party transactions from the liabilities, reducing the $6.8 million debt to $2.08 million. The fund's assets would then exceed its debts in December 2000, disallowing recovery of the $650,000.

Does the law 'compel' book value of debts?

After analyzing the parties' arguments, the court narrowed the issue to whether applicable law required it to value a debtor's liabilities at book value, as the receiver contended.

The receiver cited the Texas Uniform Fraudulent Transfer Act and its definition of insolvency: "the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation." He also cited similar language in the Bankruptcy Code, arguing that the fair valuation standard applied only to the assets and not to the debts in an insolvency determination; and that this interpretation would be consistent with the broad definition of debt under both statutes.

While the majority of the court's opinion focuses on the rules of statutory construction, it ultimately rejected the receiver's arguments. Neither the statute nor the relevant case law compelled the court to conclude "that debts can *only* be valued at book value" (emphasis in original). The insolvency definitions and "fair valuation" language permit debts to be valued at book value but do not preclude adjusted values.

Accordingly—although the court indicated some concern that the hedge fund permitted a related entity to hold its debts—the court dismissed the receiver's claims.