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

BVR staff, with analysis by Theodore D. Israel, CPA/ABV, CVA

"In order to calculate the fair market value of limited partnership interests [the] petitioner transferred as gifts," the Tax Court begins, in a nice preface to the issues presented in *Astleford v. Commissioner* (T.C. Memo 2008-128, May 5, 2008):

> …we must determine the fair market value of 1,187 acres of Minnesota farmland, whether a particular interest in a general partnership should be valued as a partnership interest or as an assignee interest, and the lack of control and lack of marketability discounts that should apply to the limited and to the general partnership interests.

In a lengthy opinion, the Tax Court considers the testimony of six appraisal experts, four for the taxpayer and two for the Internal Revenue Service. (The court does not name the business and real estate appraisers, referring to them simply as experts for either party.) It also considers the comparability of data from sales of publicly traded REITs (real estate investment trusts) to data from sales of registered RELPs (real estate limited partnerships) and—while declining to declare one dataset superior to the other—the court does examine which set of sales transaction data applies more to the facts and circumstances of the various Astleford family interests.

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Analytical note (by Ted Israel). Of particular interest to appraisers: There are two "pearls" in the Astleford *opinion. The first relates to the adoption of a fairly significant combined discount for lack or marketability and control related to a 50% general partnership interest. The second relates to the Tax Court's acceptance of a significant "tiered" discount for the multiple ownership levels inherent in the real estate partnership/limited partnership interests.*

Wealthy developer leaves all to wife

When M.G. Astleford died in 1995, he owned interests in over forty real properties located primarily in Minnesota. All of these passed through a marital trust to his wife, who formed the Astleford Family Limited Partnership (AFLP) in 1996 to "facilitate the continued ownership, development, and management" of the real estate interests and to facilitate gifts to the couple's three adult children. At the time of its formation, Mrs. Astleford retained a 10% general partnership interest in AFLP and gave each of the children a 30% limited partnership (LP) interest. The limited partners made no capital contributions at the time of any gifts and received no voting rights; no outside party could join AFLP without the consent of the general partner, who also controlled all rights regarding the sale/transfer/partition of the partnership assets.

Mrs. Astleford initially funded the AFLP in 1996 with an eldercare facility (stipulated value of nearly $900,000). In 1997, she transferred to AFLP her 50% general partnership interest in the Pine Bend Development Company (Pine Bend), which owned 3,000 acres of land, including 1,187 acres dedicated to farming (the Rosemount prop-

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Astleford *Has it All*

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erty). She gifted additional LP shares in AFLP to her children to keep the 30-30-30 ownership configuration while maintaining herself as 10% general partner (GP) in AFLP.

In her 1996 and 1997 federal gift tax returns, Mrs. Astleford declared certain values and discounts related to her respective gifts to the children. On audit, the IRS found higher fair market values for several of the properties that funded AFLP and a higher net asset value (NAV) for the entire partnership. The IRS also decreased some of the marketability and lack of control discounts related to the gifted AFLP limited partnership interests. The taxpayer's versus the IRS's assessments are shown in the table on the following page.

Through various pre-trial stipulations—and as the Tax Court neatly summarized at the start of its opinion, the parties disputed only three issues related to AFLP and its assets: 1) the fair market value of the Rosemount farmland; 2) whether the 50% Pine Bend interest should be valued as a GP or assignee interest; and 3) the applicability and amount of discounts for lack of control and lack of marketability to the gifted AFLP limited partnership interests.

'Market absorption' discount appropriate?

The taxpayer's real property appraiser considered the 1,187-acre Rosemount property to be "extraordinarily large and unique." In his market approach, he compared eighteen similar properties based on date of sale, location and size, and calculated an initial value for the Rosemount farmland of nearly $3.7 million. But a sale of the entire property would flood the local market, he believed, reducing the per-acre price for farmland and requiring a market absorption discount. Assuming the property would sell over the course of four years and would appreciate 7% per year—and using a 25% discount rate to present value the expected cash flows, which was derived from a real estate development study—the expert's final fair market value for the farm property came to $1,817 per acre for a total of $2.16 million.

The IRS appraiser also used the market approach—comparing 125 Minnesota farmland properties and personally visiting twelve. He ultimately chose two comparables, adjusted only for dates of sale (because the properties were so similar to the subject), and arrived at a fair market value for the Rosemount farmland of $3,500 per-

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	Taxpayer's gift tax returns		IRS audit determinations	
Year	Taxable gifts	Gift tax liability	Taxable gifts	Gift tax liability
1996	$277,441	$79,581	$626,898	$127,619
1997	$3,954,506	$2,005,689	$10,937,268	$3,997,288

acre or nearly $4.16 million total, almost twice as much as the taxpayer's appraiser. The IRS expert further concluded that a market absorption discount was not appropriate. The Pine Bend partnership originally purchased the 1,187 acres in a single transaction, and thus (he believed) it could also sell the tract in its entirety. Even if an absorption discount was appropriate, the IRS expert considered the 25% present-value discount rate excessive. He cited a 1997 Minn. farm business management study that showed farmers in the region earning an average rate of return on equity of 9.2%.

The Tax Court found the IRS expert to be "particularly credible and highly experienced," possessing a "unique knowledge" of the area. The court adopted his initial $3,500 per-acre finding, but believed that due to the size of the property, a sale of all 1,187 acres in a single year merited a market absorption discount. The taxpayer's discount was "unreasonably high," however, because it relied on a 25% rate of equity return that real estate developers expected to earn. In another nod to the IRS expert, the court held that his 9.2% rate of return was based on what farmers in the area were "actually earning." Rounding this figure up to 10%, applied over four years, the court found the farmland to be worth $2,786 per acre for a total fair market value of nearly $3.31 million.

Analytical note (by Ted Israel). The court indeed felt that it would be difficult for the surrounding market to absorb the 1,187 acres and applied the absorption discount. The court took exception, however, to the 25% discount rate because it was based on developers' rates of return, which contemplate greater risk. But was the 9.2% rate (which the court rounded to 10%) plucked from the IRS expert the right *rate? It was said to be based upon "the return on equity which farmers in the area were actually earning." An alternate source would be the "going in discount rate" on agricultural property in the region available from a number of surveys published by national real estate consulting firms. That rate (with a slight increment for the risk of an uncertain time horizon and appreciation rate) might have resulted in a supportable discount rate somewhere between the 10% adopted by the court and the taxpayer's 25%. Footnotes to the transcript reveal that experts for both sides accounted for transaction costs and periodic property taxes in their absorption analysis.*

Discounts for a 50% GP *and* LP interests?

The taxpayer treated the 50% Pine Bend interest as an assignee interest, based primarily on the other 50% owner's failure to consent to the transfer to the AFLP. Because, under Minn. law, an assignee would only have rights to Pine Bend's profits—and no management control—the taxpayer's expert, as a preliminary matter, discounted the assignee interest by 5%.

But the AFLP partnership resolution treated the Pine Bend transfer as one of all the taxpayer's rights and interests, the IRS pointed out. Further, as AFLP's sole general partner, the taxpayer was essentially in the same management position whether she transferred a GP or assignee interest. The substance of the transfer should trump its form, the IRS argued—and the court agreed, finding the taxpayer funded AFLP with a 50% general partnership interest.

To determine the discounts for lack of marketability and control for the 50% GP interest, the taxpayer's expert examined comparable data from sales of registered real estate limited partnerships (RELPs). He identified trading dis-

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counts (differences between unit/share trading prices and unit/share NAVs) in 17 RELP comparables and established a range of 22% to 46% for a combined lack of marketability and control discount. But then, "without explaining further," according to the court, the expert "abruptly concluded" that a 40% combined discount applied 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 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 where a taxpayer held a minority interest in an entity that in turn owned a minority interest in another entity. "The 50-percent Pine Bend interest constituted less than 16% of AFLP's NAV and was only 1 of 15 real estate investments" that AFLP held at the time of the transfer, the court said. "[L]ack of control and lack of marketability discounts at both the Pine Bend level and the AFLP parent level are appropriate."

The court eliminated four of the RELP comparables that the taxpayer's expert selected because their data came from the wrong year (1999 instead of 1997, the year of the gift). The remaining data showed median and mean trading discounts of 30% to 36%, and a 1997 sample of 130 RELPs showed a 28.7% median and 30% mean discount. Thus the court concluded that a 30% combined discount applied to the 50% GP interest that the taxpayer transferred to the AFLP, valued at nearly $1.3 million.

Analytical note (Ted Israel). An interesting methodology disconnect occurs here. The discounts for lack of control and lack of marketability related to the Pine Bend GP interest are estimated and applied on a combined basis, whereas on the overall AFLP interest discussed below, they are estimated and applied separately.

The BV profession has frequently struggled with the concept of lack of control and marketability discounts for 50% interests. Such interests generally do not enjoy control, but they clearly do not experience the same lack of control suffered by lesser interests. With little empirical data to go on, many experts have opined that the discounts do apply to a 50% interest, just to a lesser degree. Given this, the resulting 30% would appear relatively high, especially when compared to the combined discounts for lack of control and marketability of 34% applied to the subject 30% LP interest in AFLP.

It is at this point the court first discusses the appropriateness of discounting an entity inside an entity or "tiered" discounts. This has been another challenge for our profession. Many experts have put forth that if such a discount applies it must certainly be reduced. The justification frequently appears to be no more than their concern for letting the taxpayer get away with too much of a good thing. Here it seemed important to the court that Pine Bend was not the primary asset of AFLP, and it did not explicitly limit its discount based on the tiered structure of the entities.

LP discounts turn on selected comparables

In determining discounts for gifts of the limited partnership interests in AFLP, the taxpayer's expert first looked at nine RELP comparables, which had an average trading discount of 38%. Of these, four RELPs were "most comparable," with trading discounts ranging from 40% to 47%. Ultimately the expert settled on a lack of control discount for the LP interests of 45% for the first gift year (1996) and 40% for the second (1997).

But the expert's nine RELP comparables were "significantly more leveraged," the court observed, demonstrating debt-to-NAV ratios of 82% to 205% compared to AFLP's more moderate leverage of 52% debt-to-NAV. Of his selected four comparables—which he considered most similar—two had NAV's approximately five times AFLP's NAV, and the other two were "even more leveraged." Because AFLP held less debt and was inherently less risky than the compa-

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rables, the court found the taxpayer's 45% and 40% discounts "unlikely."

Moreover, because AFLP's cash distribution rate was significantly higher than the average rate of the RELPs—10% versus 6.7%—the court found that under his own approach, which conceded less risk to companies with higher cash distributions—the expert's discounts should be lower than the 38% average that he observed among the comparables. The RELP comparables were "too dissimilar" to AFLP to warrant the reliance that the taxpayer's expert placed on them, the court ruled, and his combined discounts for the LP interests were "excessive."

Rather than "[sift] through the RELP data looking for more appropriate RELPs to serve as comparables," the court turned to the IRS expert, who examined comparability data from sales of REITs. It declined to declare either the REIT or RELP data superior to the other, since prior courts have accepted expert valuations derived from both. In considering the facts of this case, the court found that RELPs more closely resembled AFLP and also the Pine Bend partnership in size, marketability, management, distribution requirements, and taxation. The low trading volume of RELPs on the secondary market also did not disqualify their data.

By comparison, the abundance of REIT sales "tends to produce more reliable data," the court noted. Any differences between REITs and the subject partnerships could be minimized by having a larger pool of REIT comparables from which to choose, and by subjecting the comparables to a methodology that accounts for their greater liquidity. In analyzing REIT data in this context, the court explained, it is appropriate to back out of their trading prices any liquidity premiums, resulting in lack of control discounts.

Taking this approach, the IRS expert obtained sales data for 75 REIT comparables, which showed that in 1996 they traded at a median 0.1% premium over per-share NAV and a 1.2% discount under per-share NAV in 1997. Using regression analysis, he concluded that REITs generally traded at a 7.79% liquidity premium over private real estate partnerships. He combined this observed premium with the respective 1996/1997 trading data to arrive at a lack of control discount for the AFLP limited partnership interests of 7.14% in 1996 and 8.34% in 1997.

Method was 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 expert suggested that the applicable liquidity premiums were nearly two times the levels he used.

A better method to derive liquidity premiums is 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. According to two studies cited by the IRS expert, this difference amounted to approximately 14%, which resulted in a general liquidity premium of 16.27% inherent in publicly traded assets and also applicable to REITs. (If an illiquid asset trades at a discount of 14% relative to a liquid asset, then the liquid asset is trading at a relative 16.27% premium, or 1/[1 - 0.14]-1 = 0.1627.)

The court eliminated or backed out this 16.27% liquidity premium from the median REIT trading data provided by the IRS expert, subtracting the .1% in 1996 and adding the 1.2% in 1997 to arrive at a lack of control discount for the AFLP partnership interests of 16.17% and 17.47%, respectively.

Analytical note (Ted Israel). A number of interesting things can be observed here. First the Court states that it has no opinion whether RELP or REIT data are more representative for purposes of estimating the discounts appropriate for an FLP. Then it says that RELPs more closely resemble the attributes inherent in AFLP. But it also observes that the capital structure of the RELPs selected by the taxpayer's expert are dissimilar to that of AFLP and reject them. With

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an insufficient number of remaining RELPs to work with, the Court resorts to using the REIT data largely because there is so much of it.

This reasoning first appeared in McCord v. Comm'r *(2003): that an absence of comparable data can be overcome by an abundance of incomparable data. With the move to the REIT data comes the need to uncouple the REIT discount or premium from the liquidity premium inherent in the REIT market prices. (Analyst's tip: There are less cumbersome ways to utilize REIT data to estimate a discount for lack of control. Hint: The* Mergerstat®/BVR Contol Premium Study™ *includes REIT takeover transactions.)*

The discounts computed in this way by the IRS expert are rejected by the court merely because they "appeared unreasonably low." That's all. Too low. The court then performed its own analysis of privately placed registered and unregistered stock to derive a liquidity premium. You can't help but wonder whether the court had some unstated benchmark lack of control discount in mind hovering in the plus or minus 20% range.

Final conclusions of value

As a final matter, the Tax Court compared the taxpayer's estimate of a 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 parties stipulated to a 22% marketability discount for the 1997 gifts and the court adopted these as well. In conclusion, it found that the fair market value of each of the taxpayer's three gifts of 30% limited partnership interests to her children were worth $172,525 in 1996, for a total taxable gift of $517,575; and that the fair market value of each 1997 gift of a 30% limited partnership interest was worth $2,188,404, for a total gift value of $6,565,215.

Analytical note (Ted Israel). We are not told how either the taxpayer or the IRS computed their lack of marketability discounts of 15% and 21.23%, respectively. We only know that without discussion of the relative merits of either's methodologies, the court could "perceive no reason not to use [the IRS's] higher marketability discount" and rounded it up to 22%. Maybe 15% was unreasonably low.

In summary, we can take away that the discounts related to both 50% interests and tiered entities are not necessarily restricted relative to other holdings and that in the final analysis, courts make their decisions based as much on their perception of reasonableness as rigorous analysis. Overall, however, this analyst thinks the Tax Court pretty much got this one right.

Final note: For more analysis, see "REIT or Wrong: Using REIT Data to Value Privately Held Real Estate Partnerships," by Ted Israel, originally published in *Valuation Strategies* (July/Aug. 2005) and available as a free download at the Echkoff Accountancy Corp. website, http://www.eckhoff.com/?option=com_docman&task=cat_view&gid=13&Itemid=7.

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