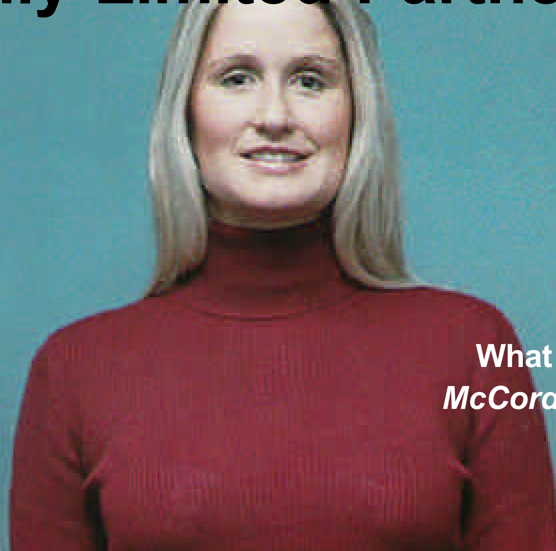
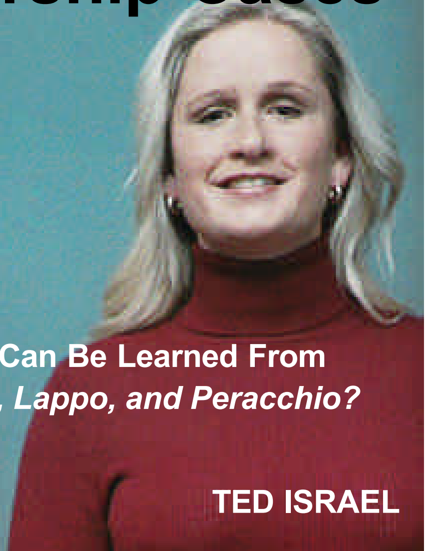
A Trio of Family Limited Partnership Cases

What Can Be Learned From *McCord, Lappo, and Peracchio?*

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When the Tax Court or courts of appeals rule in a case involving business valuation, valuation professionals eagerly pour over the case documentation to see what they can learn. The rulings frequently provide insights into the courts' disposition towards various valuation strategies and techniques. *Estate of Davis* [1] held that built-in-gains could be considered when determining a C corporation's fair market value. *Gross* [2] revealed that the tax affecting of an S corporation's profits was not an adjustment that would be automatically accepted by the Tax Court. *Barge* [3] showed how to perform a partition analysis when valuing fractional real estate interests. Is there any such guidance in our subject trio of cases? Yes, but you have to dig for it.

The Cases

The three cases are all from 2003: *McCord*,[4] *Lappo*,[5] and *Peracchio*.[6] They all involve family limited partnerships holding multiple investments. After initial skirmishes, any attempts to disqualify the partnership form were either abandoned or defeated, making these pure valuation cases. There were experts with impressive credentials on both sides of all three cases. In all three cases, the court rejected the conclusions the experts reached from their empirical data, and the court used the data to form its own conclusions. There are so many similarities between *McCord* and *Lappo* relating to minority and marketability discounts that Lappo could be called *"McCord II."*

McCord. McCord Interests, Ltd., LLP (MIL or the partnership) was formed as a Texas limited partnership in June 1995. Charles and Mary McCord and their four children contributed assets consisting of equity securities, bonds, real estate partnerships, real estate, and oil and gas interests to the partnership.

On 1/12/96 (the valuation date), the McCords entered into an assignment agreement to assign all of their class B limited partnership interests in MIL to their children, trusts for the benefit of their children, and two charitable organizations. Some class A limited partnership interests also existed, but they are immaterial to the discussion. The children and their respective trusts were made liable for the transfer taxes. The assignment agreement contained a "formula clause," which in effect increased the charitable donation if the fair market value of the gift interests exceeded a certain amount. On 6/26/96, MIL exercised its right to call the interests held by the two charities and redeemed them.

The issue came down to the valuation of two 41.167% assignee interests in MIL. The McCords and the IRS agreed that the net asset value (NAV) was $17,673,760. Both parties' experts determined their minority interest discounts by analyzing publicly traded, closed-end equity investment funds. The discount for any specific fund was derived by comparing the trading prices of its shares with the pro rata share of the fund's NAV. All discounts were to be weighted relative to the NAV of the fund or asset class to arrive at an overall minority discount for the partnership.

Minority Interest Discount. The experts dueled over the appropriate minority discounts for equity and bond funds. The court was not completely satisfied with either expert's testimony for these assets and ultimately adopted compromise figures. The IRS expert was instructed to use the McCords' discount for direct real estate holdings and oil and gas interests.

Things started to get interesting when the experts got around to the real estate partnerships (29.4% of MIL's holdings). The McCords' expert, William H. Frazier, based his analysis on "comparable" publicly traded real estate companies. The IRS expert, Mukesh Bajaj, favored the use of real estate investment trusts (REITs). Mr. Frazier identified only five companies and included only three when deriving his range of discounts. The court did not consider his choices comparable or his sample large enough. Dr. Bajaj, on the other hand, included sixty two REITs in his analysis.

Dr. Bajaj's data yielded a median price-to-NAV premium of 3.7%. However, Dr. Bajaj explained that the difference between price and NAV had two components; one positive (a liquidity premium) and one negative (the minority discount). The liquidity premium exists because the REIT allows the investor to own an illiquid asset (real

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estate) in liquid form. Dr. Bajaj elected to obtain his overall NAV adjustment from the lower 25th percentile of his data. He believed that these REITs were more comparable due to MIL's distribution policy. The lower percentile REIT's traded at a 1.3% discount from NAV.

To arrive at the minority discount, the liquidity premium would have to be calculated and added to the 1.3% net discount. Dr. Bajaj based this adjustment on his analysis of privately placed restricted stock. His analysis of registered and unregistered private placements will be discussed in more detail below under marketability discounts, but, in summary, it was his opinion that only 7% of the discounts observed in such analysis are related to illiquidity. He converted this discount to a 7.53% premium: [1 / (1 - 7%)] - 1. By combining the 1.3% net discount with the 7.53% liquidity premium, he arrived at an 8.83% minority interest discount.

Now, it starts getting really interesting. For reasons discussed below under marketability discounts, the court did not agree with his derivation of the liquidity premium. Instead, the court used the overall 17.6% average discount observed between unregistered and registered private placements reflected in one the studies relied on by Dr. Bajaj[7] and rounded it to 18%. Employing the same formula used by Dr. Bajaj, the court converted the 18% liquidity discount to a 22% liquidity premium. By combining this 22% liquidity premium with the 1.3% net discount, the court arrived at a minority interest discount of 23.3% for MIL's real estate partnership interests.

The court adopted an overall minority interest discount of 15% weighted by asset class. The court's differentiation between liquidity and marketability should be kept in mind. It will be discussed later in the article.

Marketability Discount. The experts agreed that empirical studies of marketability discounts fall into two categories: IPO studies and restricted stock studies. The IPO studies compare the price of shares before and after an initial public offering (IPO). The difference or discount is attributed to the pre-IPO shares' lack of marketability. The restricted stock studies compare transaction prices of restricted shares in public companies with their unrestricted counterparts. Again, the difference or discount is attributed to the restricted shares' lack of marketability.

Mr. Frazier relied primarily on the restricted stock studies in arriving at a 35% marketability discount. He also contended that the IPO studies strongly support this level of discount.

Dr. Bajaj argued that the IPO studies offered flawed evidence. He believed that a pre-IPO purchaser demands a lower price as compensation for the risk that the IPO will not occur or will occur at a lower-than-projected price. He also believed that pre-IPO buyers are frequently insiders that are being compensated for their services through a lower price. He concluded: "The IPO approach probably generates inflated estimates of the marketability discount. Consequently it is of limited use in estimating the value of closely held firms." Dr. Bajaj further offered what the court considered compelling criticism of several of the well-known IPO studies. According to the court: "Dr. Bajaj has convinced us to reject as unreliable Mr. Frazier's opinion to the extent that it is based on the IPO approach."

The court found flaws in Mr. Frazier's testimony regarding his use of restricted stock studies. It felt that he failed to adequately relate MIL's key operating elements to those in the studies. Consequently, the court gave little weight to his restricted stock analysis.

The court next considered Dr. Bajaj's analysis of restricted stock transactions. Dr. Bajaj believed that discounts observed in restricted stock studies are attributable in part to factors other than impaired marketability. To support his position, he provided data from studies involving registered private placements and unregistered private placements (the private placement studies).[8]

His hypotheses was the following: If the discounts found in the unregistered (restricted) private placements are attributable solely to impaired marketability, there should be no discounts associated with registered private placements because the latter shares are publicly marketable. However, the studies indicate that even the registered shares experienced a discount, although it was generally lower than that of the unregistered shares. Dr. Bajaj believed that this incremental discount relates to the unregistered share's higher assessment and monitoring costs. He identified several attributes that he considered indicators of the higher assessment and monitoring costs, and isolated their effect through statistical analysis. As a result of his analysis, he concluded that an unregistered share suffers only an incremental discount of 7.23% related to its inability to be immediately sold. It was his opinion that an appropriate marketability discount for MIL was 7%.

The court was impressed with Dr. Bajaj's analysis. However, it pointed out that he had isolated the liquidity portion of the discount, and the court was unable to accept that liquidity alone equated to marketability. "[H]is apparent confusion regarding the nature of the discount for lack of marketability (i.e., whether such discount can be explained purely in terms of illiquidity or whether other factors may be involved) is troubling....Therefore, while we are impressed by portions of Dr. Bajaj's analysis, he has not convinced us that

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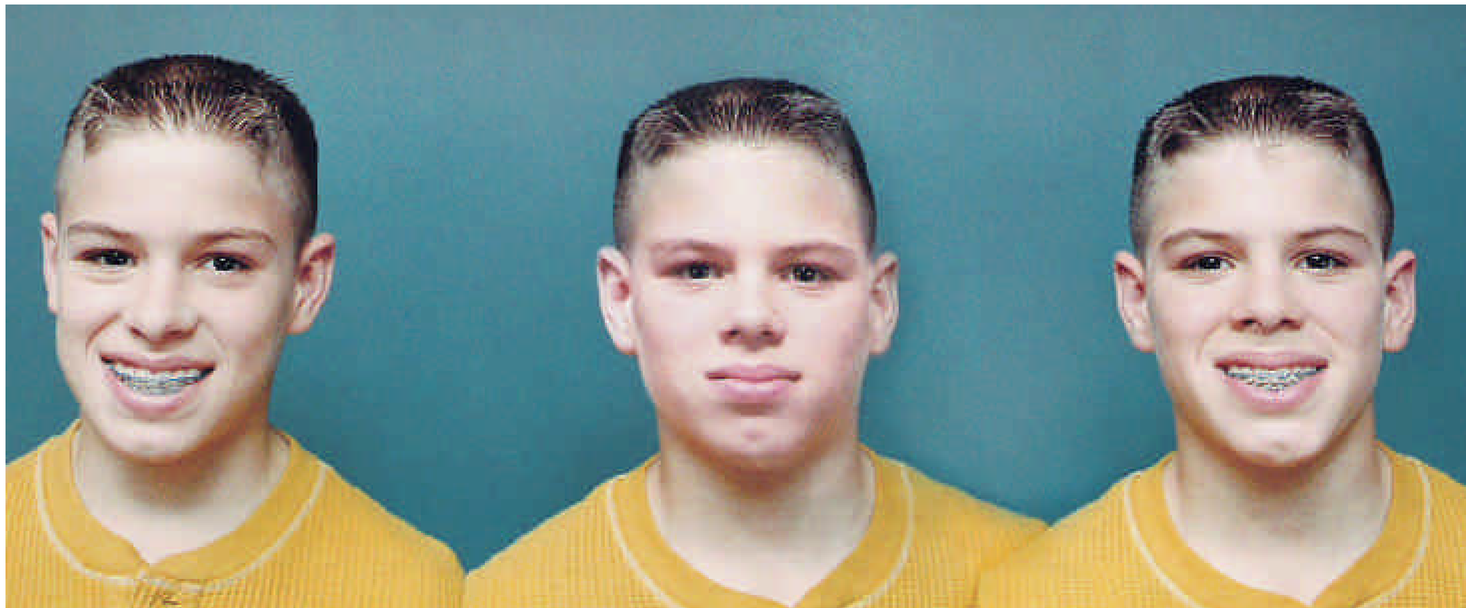

the appropriate marketability discount in this case can be inferred from the illiquidity cost associated with private placements."

The court proceeded to relate MIL's characteristics to the middle group of private placements in Dr. Bajaj's study[9] from which it plucked an average discount of 20.36%. The court concluded that a 20% marketability discount was appropriate for MIL.

Recall that when the minority interest discount for the MIL's real estate partnerships was being derived, the focus was on removing the liquidity premium. When deriving the marketability discount, the court clearly stated that the discount is not defined by illiquidity alone. However, it appears that the court used nearly the same magnitude of discount/premium for each. Thus, it appears that some marketability discount might have been incorporated into the minority discount. Could it be that the taxpayer got the benefit of a "double dip"?

Lappo. In October 1995, Clarissa Lappo and her daughter, Clarajane, formed the Lappo Family Limited Partnership (the partnership). In April 1996, Clarissa and Clarajane conveyed a portfolio of securities and parcels of real estate into the partnership. The securities were primarily municipal bonds. The real estate had historically been the site of the Lappo family's lumber business. At the time of transfer, the real estate was leased to a national lumber retailer. In April and July of 1996, Clarissa gave limited partnership interests to Clarajane, her four grandchildren, and the Lappo Generation Trust of which Clarajane was trustee.

A notice of deficiency relating to the gift tax returns was issued 6/19/01. A number of contentions were raised in the notice. By the time of trial, the only remaining issue was the valuation of the 1996 gifts of the limited partnership interests.

Much was agreed or stipulated to. The parties agreed that the valuation should be based on NAV less minority and marketability discounts. They even agreed on the NAV itself. They stipulated to an 8.5% minority discount for the partnership's securities holding. The magnitude of the minority discount for the real estate holdings and the overall marketability discount were disputed.

The rest of the case is remarkably similar to *McCord*. Many of the IRS expert's positions seem very familiar. Although Dr. Bajaj was not the IRS expert in this case, his work was frequently cited, as was *McCord* and *Estate of Heck*.[10] In fact, the IRS expert was Alan C. Shapiro who, along with being a distinguished professor at the University of Southern California, is also an outside director of LECG, LLC, of which Dr. Bajaj is the managing director. Presumably, the two share at least some resources and methodologies.

Minority Interest Discount. The two experts were in agreement that publicly traded REITs provide useful guidance in determining the appropriate minority interest discount for a real estate partnership. However, they did not agree on the selection of REITs on which to base their analysis.

Clarissa's expert, Robert P. Oliver, started with a listing of more than 400 REITs and real estate companies. In seeking comparable companies, he eliminated all but seven (three REITs and four real estate companies). The court rejected Mr. Oliver's selection as insufficient in both comparability and size. The court also felt that Mr. Oliver did not adequately explain adjustments he made to the capital structure of his comparable companies to arrive at their NAV.

The following should sound familiar: Dr. Shapiro started with 62 real estate companies and eliminated all that were not REITs, leaving him with 52 for his analysis. The 52 REITs in the sample traded at a median 4.8% premium over NAV.

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1 110 TC530 (1998).
2 272 F.2d 333, 88 AFTR2d 2001-6858 (CA-6, 2001).
3 TCM 1997-188.
4 120 TC 358 (2003).
5 TCM 2003-258.
6 TCM 2003-280.
7 Wruck, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings," 23 J. Fin. Econ. 3 (1989).
8 Bajaj, Denis, and Ferris, "Firm Value And Marketability Discounts," 27 J. Corp. L. 89 (2001); Wruck, note 7 *supra*; Hertzel and Smith, "Market Discounts and Shareholder Gains for Placing Equity Privately," 48 J. Fin. 459 (1993).
9 Bajaj, Denis, and Ferris, note 8 *supra*.
10 TCM 2002-34.
11 Bajaj, Denis, and Ferris, note 8 *supra*.
12 TCM 1995-255.
13 See in this issue, Easton, "Section 2036 Hurdle Raised for Family Limited Partnerships," 7 Val. Strat. 4 (January/February 2004).

He went below the median to the 15th percentile to better match his REITs to the partnership in terms of distribution policies. This group traded at a 0.8% discount to NAV on 3/25/96 and a 1.48% *premium* over NAV on 6/25/96. Dr. Shapiro next isolated and removed the liquidity premium from the overall premium and discount. He determined that a 7.5% liquidity adjustment was appropriate based on the work of Dr. Bajaj.[11] He concluded that the appropriate minority interest discounts for the real estate portion of the partnership were 8.3% (-0.8 minus 7.5) as of 4/19/96 and 6% (1.48 minus 7.5) as of 7/2/96.

Once again, the court rejected the 7.5% liquidity adjustment and computed its own. Based on the data in studies cited by Dr. Shapiro, the court arrived at a 17.6% liquidity premium. The court concluded that as of 4/19/96 and 7/2/96, the minority discount for the partnership's real estate assets should be 18.4% (-0.8 minus 17.6) and 16.12 (1.48 minus 17.6) respectively. The court rounded the discount up to 19% for both valuation dates. The court adopted an overall minority interest discount, weighted by asset class of 15%.

Marketability Discount. Mr. Oliver determined his marketability discount based on restricted stock studies. The court did not agree with his selected guideline group and gave his testimony little weight.

Dr. Shapiro went down the same road as Dr. Bajaj in *McCord* and contended that the private placement stock studies he used indicated a 7.2% marketability discount. He adjusted the discount upward to 8.3% based on other factors. The court cited *McCord* in justifying its rejection of 7.2% as the appropriate starting point for determining the partnership's marketability discount. The court once again examined the data in the cited studies, which indicated an average discount of 21%. Based on its assessment of characteristics specific to the partnership, the court adjusted the discount upward to 24%.

Peracchio. Other than dealing with a family limited partnership, *Peracchio* has little in common with *McCord* or *Lappo*.

There are no benchmark or automatic discounts for either minority interest or marketability discounts.

On 11/25/97, (the valuation date), Peter Peracchio formed Peracchio Investors, L.P. (the partnership). Peracchio contributed cash and securities with a stated value of $2,013,765 to the partnership in exchange for a .5% general partner interest and 99.4% limited partner interest. Peracchio's son contributed $1,000 for a 0.05% general partner interest. A trust created by Peracchio and his wife on the same date, contributed $1,000 in exchange for a 0.05% limited partner interest. Also on the valuation date, Peracchio gave 0.45% of the partnership's equity to his son and 45.47% to the trust. Peracchio also transferred 53.48% to the trust in exchange for a promissory note of $646,764. In the timely filed gift tax return, Peracchio valued the 0.45% gift at $9,070 (9.0788 partnership units multiplied by their designated "per unit" value of $1,000) and the 45.47% gift at $550,000 (916.677 partnership units multiplied by $1,000 less a 40% discount for lack of control and marketability).

In the notice of deficiency, the Service rejected Peracchio's discounted values used for the gift and sale transactions based on its usual arguments. By the time of trial, the IRS had abandoned most of the entity substance arguments and was willing to allow a minority discount of 4.4% and marketability discount of 15%.

Minority Interest Discount. The parties agreed that NAV less minority and marketability discounts was the proper approach to value the partnership. They further agreed that the minority discount should be based on the discounts from NAV observed in publicly traded closed-end investment funds. The respective experts even used the same data source. However, Peracchio's expert, Timothy R. Dankoff, relied on data from 10/24/97, whereas the IRS expert, Francis X. Burns, used

EXHIBIT 1
The Big Picture: Where the Parties Started and Where They Wound Up

	McCord	Lappo	Peracchio
Taxpayer's position (discounts taken at date of original filing):			
Minority interest	22%	15%	N/A
Marketability	35%	35%	N/A
Effective overall (Total discount/Gross value)	49.3%	45%	40%
IRS position on notice of deficiency:			
Minority interest	None*	None*	None*
Marketability	None*	None*	None*
Effective overall (Total discount/Gross value)	None*	None*	None*
IRS position at trial:			
Minority interest	8.34%	7%	4.4%
Marketability	7%	8.3%	15%
Effective overall (Total discount/Gross value)	14.65%	15%	18.74%
Result of trial:			
Minority interest	15%	15%	6%
Marketability	20%	24%	25%
Effective overall (Total discount/Gross value)	32%	35.74%	29.5%

*IRS sought to deny entity substance, business purpose, etc.

data from the valuation date. Consequently, the court favored the Service's price-to-NAV ratios.

There was further disagreement between the experts over how to use the data. Mr. Dankoff eliminated what he referred to as "outliers," and used the median discount. The court thought that the mean discount was more appropriate given that the effects of any extreme values were mitigated by eliminating the outliers. The court's approach came up with minority interest discounts for the partnership's asset classes consistent with the experts' discounts. The exception was cash, which made up 44% of the partnership's assets. Here, neither expert offered any compelling testimony. Mr. Dankoff used a judgmentally derived 5%. Mr. Burns used 2%. The court adopted 2%, stating that the IRS "has effectively conceded 2%" and the taxpayer "has failed to carry his burden of persuading us that a figure in excess of 2% would be appropriate." The weighted average minority discount for the partnership was 6% rounded.

Marketability Discount. There was not much offered by either side in support of their opinions regarding marketability discounts. Peracchio's experts were shooting for a 35% discount. They contended that the Tax Court in *Mandelbaum*[12] set some sort of benchmark range of discounts in the 35%-45% range. The court disagreed. Peracchio's experts also made reference to restricted stock studies and the range of discounts implied therein, but without relating them in any way to the partnership. Mr. Burns's written report stated that the marketability discount should be in the range of 5% to 25%, but it did not offer any real quantitative support for the 15% he claimed.

The court was frustrated with the lack of a cogent argument from either side and effectively split the difference:

> (R)espondent's expert states in his written report that a marketability discount above 25 percent would not be justified for an entity with the characteristics of the partnership. We treat that statement as a concession that a marketability discount of up to 25 percent (rather than the arbitrarily selected 15 percent) would be appropriate for the transferred interests. Because petitioner has failed to carry his burden of persuading us that a figure in excess of 25 percent would be appropriate, we utilize a 25 percent marketability discount for purposes of determining the fair market value of the transferred interests.

Conclusion

There is much to be learned from this trio of cases. Some of the lessons are reminders of good practices that can always stand a little reinforcement. Others are new. They either validate methodologies that have not been litigated before, or they indicate a trend.

Reinforcement of Good Practices. There are no benchmark or automatic discounts for either minority status or lack of marketability. Citation of case law or reference to overall means and medians from studies will not meet the taxpayer's burden to persuade the court. Experts must mine the data in the surveys and draw inferences only from data that is comparable to the subject entity.

Sufficient data must be selected and analyzed. The Tax Court in *McCord* and *Lappo* made clear that it would rather draw inferences from a large amount of general data than a small amount of "comparable" data if it believes that the comparable data is not so comparable.

Validation of Methodology. The discount from NAV observed in publicly traded REITs is composed of both a liquidity premium and a minority discount. The liquidity premium must be isolated and removed in order to derive the minority discount properly.

Trends. In the three opinions, marketability is not defined by liquidity alone. It will be interesting to see where this trend goes. Does the court really believe that marketability takes in more than liquidity, or could it just not intuitively accept a 7% marketability discount?

Care must be taken when citing IPO studies in support of marketability discounts. It is hard to know whether the court's treatment of the IPO studies in *McCord* will be viewed as specific to that case or of general application in future cases.

It would appear, for the time being, that the discounting of family limited partnership interests is alive and well for gift tax purposes. In all three of the cases, the IRS abandoned its economic substance attacks on the partnerships by the date of trial. Once the entities were acknowledged as valid, there was no argument against the applicability of discounts. As can be seen in Exhibit I, the taxpayers did not have to come down as far in their discounts as the IRS had to come up.

However, that is not the end of the story. Even if the gift tax return survives an audit (or is successfully litigated), there is still risk that the plan can come apart. Disregard of the partnership form, such as the transferor's continued exercise of control, can make an estate vulnerable to a Section 2036(a) challenge by the Service upon the transferor's death.[13]

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