

# VALUATION OBSERVATIONS

*Some practical observations from a practicing  
business appraiser.*

## VLC

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### ***WEALTH PROTECTION AND TRANSFER – AND SAVE TAXES TOO?***

A family limited partnership (FLP) or a limited liability company (LLC) is an estate planning tool that can allow an individual to make substantial transfers of assets in a tax-efficient manner while still maintaining extensive control over those assets. An FLP or LLC is established by transferring assets into a partnership in exchange for general and limited partnership or membership interests. The general partner/managing member maintains complete control over assets held by the entity but can transfer the limited partnership or non-managing interests that make up the bulk of the value of these assets to family members.

FLP and LLC interests qualify for substantial discounts for a variety of reasons. Limited partners and non-managing members have no say regarding management of assets and typically have very narrow abilities to sell or transfer their interests. Any distributions are at the complete discretion of the general partner/managing member.

FLPs and LLCs also help insulate assets from claims by creditors. Parents concerned that their children may lose assets due to lawsuits or divorce find this feature attractive. In addition, unlike most trusts, the general partner or managing member can retain the right to modify the partnership/operating agreement without causing assets in the entity to revert to his or her taxable estate.

FLPs and LLCs can be an effective way for families with significant real estate or other holdings to effectively manage the intergenerational transfer of such assets while minimizing potential estate and gift taxes. One reason FLPs and LLCs are so valuable in estate planning is that the interests issued to potential heirs qualify for substantial discounts from net asset value because limited partners and non-managing members have virtually no control over their interests in the entity.

Downward trends in valuation discounts for minority interests in publicly registered real estate partnerships raise concern that the discounts available to FLPs and LLCs may be shrinking. *Direct Investments Spectrum* (formerly known as *Partnership Spectrum*), published by Partnership Profiles, Inc., shows the discount for all publicly registered partnership transactions dropping from 48 percent in 1994 to 23 percent in 2003. This is evidence of a steep decline.

Beware – public partnerships are not always comparable. While publicly registered real estate partnerships aren't exactly analogous to FLPs and LLCs, valuation professionals often look at trading activity for such partnerships that hold assets similar to the FLP or LLC they are valuing. One should be

careful, however, not to rely too heavily on the comparability of these entities. First, the asset mix in FLPs and LLCs is often less diverse than that held in a publicly registered partnership. In addition to real estate, an FLP or LLC may include family business interests, securities, and other investment property.

Second, the investment time horizon for a publicly registered partnership may well be shorter, even dramatically shorter, than that of an FLP or LLC. Over the past few years, the average holding period for limited partnership interests in publicly registered partnerships has declined by about 50 percent from 8 to 10 years to 2 to 5 years. Since investors are willing to pay more for a short-term payoff, this change in holding periods can drive the discount available for such limited interests down. Conversely, an FLP or LLC may have a significantly longer holding period.

Third, public partnerships must register with the SEC, generally hold properties that are more geographically diverse than those in FLPs and LLCs, and increasingly announce liquidation or distribution plans. All these characteristics make public partnerships more attractive to investors and serve to decrease the potential discount available for limited interests.

Finally, FLPs and LLCs have been very successful in defending even substantial discounts in Tax Court. The IRS aggressively targeted FLP discounts in the 1990s, but taxpayers generally were so successful in these cases that the IRS has backed off considerably in targeting these discounts.

So what is the bottom line? While decreasing discounts in public partnerships certainly are a factor when valuing limited FLP interests and non-managing LLC interests, valuers shouldn't hesitate to consider the key differences between FLPs/LLCs and public partnerships and should base the discount on the specifics of each case. Simply basing a valuation on discounts among public partnerships could well lead to overvaluation of FLP/LLC interests.

If you would like additional information, or have a question, please do not hesitate to call.

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