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# Valuation Implications of the Proposed Changes to Section 2704

by Z. Christopher Mercer, FASA, CFA, ABAR


## Executive Summary

In this white paper, we examine the recently proposed changes to Section 2704 of the Internal Revenue Service Code from business and valuation viewpoints. The express goal of the Proposed Changes is to eliminate, or virtually so, valuation discounts in family partnerships (and operating companies, as well). The instruments of change are a loosened definition of control (to broaden the number of families having control), almost total family attribution of control for every transfer, and a hypothetical put right to the partners in family partnership to facilitate the elimination or reduction of valuation discounts in fair market value determinations. A review from business and valuation perspectives finds that the Proposed Changes, if adopted as published, will affect, but not eliminate valuation discounts.



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## In This Whitepaper

The Department of the Treasury and the Internal Revenue Service published a document titled **Estate, Gift, and Generation Skipping Transfer Taxes: Restrictions on Liquidation of an Interest** on August 2, 2016. The document is also published in the **Federal Register**.

Both documents provide certain proposed changes to Section 2704, provide discussion surrounding the history of Section 2704, and discuss the proposed changes. We refer to the documents as providing "the Proposed Changes" to Section 2704.

The express intent of the Proposed Changes is to eliminate, or virtually so, the typical valuation discounts that are applied in fair market value determinations of limited partnership interests in family partnerships. This paper will raise some questions about whether the Proposed Changes actually do so.

The Treasury and IRS believe that they have the authority to issue the Proposed Changes – *"if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee."*

The premise of the Proposed Changes is, therefore, that restrictions on transfer do not "ultimately reduce the value of the interest to the transferee." Ultimately is a long time. It is not uncommon with family partnerships that interest holders receive less than net asset value for their interests. This happens through the operation of buy-sell agreement provisions and otherwise.

This whitepaper is based on a preliminary review of the Proposed Changes. Any discussion of authority to issue the Proposed Changes is beyond this author's background as a businessman and valuation expert. Accordingly, issues are addressed only from business and valuation perspectives. In addition, this paper quotes extensively from the proposed regulation and other sources. The text we emphasize appears in bold.

# Attribution of Complete Control to the Extended Family

The Proposed Changes include the aggregation of ownership interests or voting rights of a family to determine if the family controls a partnership (or S corporation or C corporation or limited liability company, as clarified).

> For purposes of section 2701, a controlled entity is a corporation, partnership, or any other entity or arrangement that is a business entity within the meaning of section 307.7701-2(a) of this chapter, immediately before a transfer, by the transferor, **applicable family members, and/or any lineal descendants of the parents of the transferor or the transferor's spouse**. (Proposed 2702-2(i))

The aggregation of control of a family partnership considers all ownership, whether direct or indirect. This is a sweeping definition of a controlled entity. This suggests that brothers of the same mother or father are family members for purposes of aggregating control.

What actually constitutes control under the Proposed Changes? The threshold has been lowered. The **proposed definition of control** of an entity would constitute the collective holding of **at least 50 percent** of either the capital or profits interests of the entity, or the holding of any equity interest with the ability to cause the full or partial liquidation of the entity. This apparently means, in a family situation, that if two siblings each hold 50% of a family entity, control is attributed to both of them, whereas before, neither would have been deemed to be a controller.

Further, under the Proposed Changes, the family members are assumed to exercise their control to allow any relevant restrictions on transfer or liquidation to be eliminated.

## Applicable Restrictions and Disregarded Restrictions

Applicable restrictions are to be disregarded.

> For purposes of subtitle B…, if an interest in a corporation or partnership (an entity) whether domestic or foreign, is transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, **any applicable restriction** is disregarded in valuing the transferred interest. (Proposed 2704-2(a))

Applicable restrictions are described in terms of their potential effects in the Proposed Changes. Consider the following:

- Applicable restrictions **do include** restrictions that are imposed under governing documents like partnership agreements or buy-sell agreements.
- However, proposed Section 2704-2(a) states (as currently) that if an interest is transferred to or for the benefit of a member of the transferor's family, and the *family controls the entity immediately prior to the transfer, any applicable restriction is disregarded in valuing the transferred interest.*
- A restriction is an applicable restriction if it will lapse under its terms at any time after a transfer, or is capable of being removed by one or more family members acting individually or collectively.

In other words, the attributed family control of an entity trumps any restrictions in the governing documents. What about "**disregarded restrictions**"?

> The term disregarded restriction means a restriction that is a limitation on the ability to redeem or liquidate an interest in an entity that is described in one or more of paragraphs (b)(1)(i) through (v) of this section, **if the restriction, in whole or in part, either lapses after the transfer or can be removed by the transferor or any member of the transferor's family** (subject to paragraph (b)(4) of this section, either alone or collectively. (Proposed 2704-3(b))

Rather than quote extensively about the restrictions noted above, we summarize the discussion.

1. Disregard any provision that **limits (or permits the limitation of) the ability of the holder of the interest to compel liquidation** or redemption of the interest. There is a presumption, for valuation purposes, that the family can exercise the ability to liquidate all or a portion of a family partnership.
2. Disregard any provision that **limits the amount to be received by the holder of the interest** on liquidation or redemption **to an amount not less than "minimum value."** Minimum value is defined, effectively, as the fair market value of the partnership's assets less relevant liabili-

ties, so net asset value (on a market value basis) and minimum value are equal to each other. For example, any provision that limits value to less than minimum value, like provisions in a buy-sell agreement that call for valuation at a discounted level (i.e., at the level of the interest) would be disregarded.

3. Disregard any provision that would **defer the payment (to the holder) of the full liquidation or redemption amount for more than six months after the holder gives notice**. The intent here seems to be to substantially eliminate the concept of an investment holding period in valuing minority interests in family partnerships.

4. Disregard any provision that would **permit the payment of liquidation or redemption proceeds (to the holder) in any form other than cash or property** (with property being valued at fair market value), so notes may not be issued (to the holder). There is a limited exception to the noted guidance for operating companies. This provision is attempting to assure there is no discounting based on the consideration to be received.

There is no mention of hypothetical willing buyers or sellers in the Proposed Changes. The "holder" discussed above is presumably the hypothetical willing seller of a subject interest who then conveys the interest in a hypothetical transaction to the next holder, the hypothetical willing buyer. As we will see, the distinction between the hypothetical willing buyer and seller is critical to this analysis of the Proposed Changes, which obscure or attempt to eliminate the distinction between buyers and sellers.

## The Put Right of Proposed Section 2704-3

An assumed put right for holders of family partnerships is assumed in Proposed Section 2704-3. This is a central component of the Proposed Changes. Holders are assumed to have a right to put their interests to the relevant family entity.

> Any restriction that otherwise would constitute a disregarded restriction will not be considered a disregarded restriction if each holder of an interest in the entity has a put right as described in paragraph (b)(6) of this section. (Proposed Section 2704-3(b)(5)(v))

The put is described as follows:

> The term put right means a right, enforceable under applicable local law, to receive from the entity or from one or more other holders, on liquidation or redemption of the holder's interest, within six months after the date the holder gives notice of the holder's intent to withdraw, cash and/or other property with a value that is at least equal to the minimum value of the interest determined as of the date of the liquidation or redemption … For purposes of this paragraph (b)(6), the term other property does not include a note or other obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by one or more persons related either to the entity or any holder of an interest in the entity… (Proposed Section 2704-3(b)(6))

The fictitious put right of the Proposed Changes assumes that every holder has a put right to receive proceeds at minimum value within six months of it being exercised. The put right is central to the intent of the Proposed Changes to eliminate (or virtually so) typical valuation discounts for family partnerships.

## Fair Market Determinations under the Proposed Changes

With this background, we move to valuation instructions in the Proposed Changes to see how they appear to be looking at valuation. We have repetition of the theme of attributed control at the outset.

> For purposes of subtitle B … , and not withstanding any provision of section 25.2704.2, if an interest in a corporation or partnership (an entity), whether domestic or foreign, i**s transferred to or for the benefit of a member of the transferor's family, and the transferor and/or members of the transferor's family control the entity immediately before the transfer, any restriction described in paragraph (b) of this section is disregarded**, and the **transferred interest is valued** as provided in paragraph (f) of this section. (Proposed 2704-3(a))

We move directly to paragraph (f) to understand how the drafters of the Proposed Changes see the valuation process unfolding. Regarding restrictions that are disregarded, the proposal states:

> If a restriction is disregarded under this section, the **fair market value** of the transferred interest is **determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, or otherwise**. (Proposed 2704-3(f))

That is the extent of paragraph (f). Note the following:

- Appraisers are to use the standard of value known as **fair market value**. This is important, because appraisers have been making fair market value determinations for many years.
- The subject of the valuation upon transfer is the **transferred interest**. The distinction between the transferred interest and the entity in which it represents ownership is also important.
- Appraisers are to employ **generally applicable valuation principles**. This guidance apparently means that appraisers are to follow typical appraisal standards like the *Uniform Standards of Professional Appraisal Practice* (USPAP), the *Principles of Appraisal Practice and Code of Ethics* (PAPCE), and the *ASA Business Valuation Standards* of the American Society of Appraisers in their fair market value determinations, as well as generally accepted valuation methods and approaches.
- Finally, in determining fair market value, **appraisers are to assume that all disregarded restrictions do not exist** in the governing documents or anywhere. The instruction to disregard existing restrictions that are real and binding on the actual holders of interests in family **partnerships forces appraisers to make hypothetical assumptions and render hypothetical appraisals**.

According to the PAPCE, we learn:

> **A hypothetical appraisal is an appraisal based on assumed conditions which are contrary to fact or which are improbable of realization**. The Society takes the position that

> there are legitimate uses for some hypothetical appraisals, but that it is improper and unethical to issue a hypothetical appraisal report unless (1) the value is clearly labeled as hypothetical (2) the legitimate purpose for which the appraisal was made is stated and (3) the conditions which were assumed contrary to fact are set forth.

In USPAP, we have the concept of extraordinary assumptions and hypothetical conditions. The assumption about disregarded restrictions would not be an extraordinary assumption (in our opinion). However, it would be a hypothetical condition, which is defined as:

> Hypothetical Condition: a condition, directly related to a specific assignment, which is **contrary to what is known by the appraiser to exist** on the effective date of the assignment results, but is used for the purpose of analysis.
>
>> Comment. **Hypothetical conditions are contrary to known facts about physical, legal, or economic characteristics of the subject property**; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.

Standard 10 of USPAP, "Business Appraisal, Reporting," addresses hypothetical conditions:

> The content of an Appraisal Report must be consistent with the intended use of the appraisal and, at a minimum: … **clearly and conspicuously state** all extraordinary assumptions and **hypothetical conditions; and state that their use might have affected the assignment results**;… (Standards Rule 10-2(a)(x))

It would appear that under the Proposed Changes every appraisal rendered for gift and estate taxes purposes would have to be labeled as a hypothetical appraisal. Every appraisal rendered for gift and estate tax purposes under USPAP (as almost all are) would have to note the assumed hypothetical conditions. Ignoring applicable restrictions and disregarding restrictions that are otherwise in place and binding on the parties to family partnerships are clearly hypothetical conditions. This paper has not yet researched the standards of other organizations, but we are fairly confident they will have similar provisions noting hypothetical assumptions and requiring hypothetical appraisals.

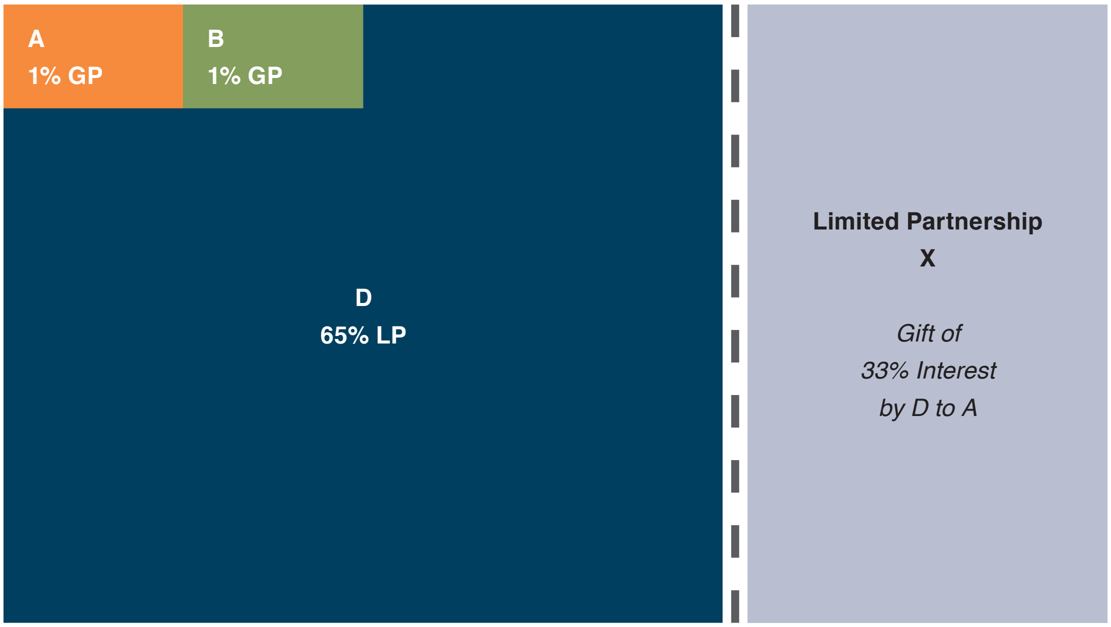
## An Example to Focus on Relevant Valuation Issues

With this background, we will look at one example of an instructional transfer found in paragraph (g) of the section immediately following the above quote. The example will be a vehicle to help examine what valuation under the Proposed Changes might be like.

> (g) Examples. The following examples illustrate the provisions of this section.
>
> (i) D and D's children, A and B, are partners in Limited Partnership X that was created on July 1, 2016. D owns a 98 percent limited partner interest, and A and B each own a 1 percent general partner interest. The partnership agreement provides that the partnership will dissolve and liquidate on June 30, 2066, or by the earlier agreement of all the partners, but otherwise prohibits the withdrawal of a limited partner. Under applicable local law, a limited partner may withdraw from a limited partnership at the time, or on the occurrence of events, specified in the partnership agree-

ment. **Under the partnership agreement, the approval of all partners is required to amend the agreement**. None of these provisions is mandated by local law. D transfers a 33 percent limited partner interest to A and a 33 percent limited partner interest to B. (Proposed 2704-3(g))

We have the example transfer. Nevertheless, D makes a gift of a 33% limited partnership interest to each of A and B. The question is, under the Proposed Changes we have been discussing, what is the fair market




value of a 33% limited partnership interest? We focus on one gift for simplicity, as shown in the figure below.

Before (and following) the gifts, A and B, as general partners, control Limited Partnership X. The example calls for two gifts, but the analysis will not change if we focus just on the gift of a 33% interest by D to A. D's interest is reduced to a 65% limited partnership interest.

We assume that the restrictions on a limited partner's ability to liquidate are **disregarded** because the partners collectively **could remove** that restriction. Note that they don't, but through the power of family attribution, they are assumed to do so hypothetically. The comments above regarding appraisal standards bring this observation into focus.

We look now at the results of the example in paragraph (g) before discussing valuation in more detail.

(ii) By prohibiting the withdrawal of a limited partner, the partnership agreement imposes a restriction on the ability of a partner to liquidate the partner's interest in the partnership that is not required to be imposed by law and that may be removed by the transferor and members of the transferor's family, acting collectively, by agreeing to amend the partnership agreement. **Therefore, under section 2704(b) and paragraph (a) of this section, the restriction on a limited partner's ability to liquidate that partner's interest is disregarded in determining the value of each transferred interest. Accordingly, the amount of each transfer is the fair market value of the 33 percent limited partner interest determined under generally**

**applicable valuation principles taking into account all relevant factors affecting value including the rights determined under the governing documents and local law and assuming that the disregarded restriction does not exist in the governing documents, local law, or otherwise**. See paragraphs (b)(1)(i) and (f) of this section. (Proposed 2704-3(g))

What guidance can we glean from this explanation of the first example?

- The partnership agreement has a requirement prohibiting any partner from withdrawing from the partnership. Partnerships have business purposes, and it generally is not conducive to their business purposes to allow for the withdrawal of any partner unless all partners agree.
- This restriction is not required by law.
- The transferor, D, and his family collectively **could** agree to amend the partnership agreement, so they are assumed to do so for purposes of the fair market value determination. This restriction is therefore **disregarded** in the valuation process.
- Appraisers are to determine the fair market value of a 33% interest under generally accepted valuation principles taking into account all factors affecting value from the viewpoints of hypothetical willing buyers and sellers, including the fact that disregarded restriction(s) do not exist for valuation purposes.

Given the brevity of the example in the Proposed Changes, we make a few assumptions to focus on typical factors that appraisers must take into account in fair market value determinations. To make the example as simple as possible, assume that Limited Partnership X is a securities-only family partnership holding a diversified portfolio of large capitalization publicly-traded securities. The portfolio's current market value is $10 million.

We make the following assumptions or observations:

1. Other than the disregarded restrictions, the partnership has "normal" terms and conditions that give rights to the general partner(s) to run the entity and that have an effect on limited partners.
2. The partnership will therefore be run by A and B who, as general partners, have operational control. The hypothetical willing buyer does not know what they will do with the management of the partnership, a fact that creates uncertainty. A and B can change their minds regarding investment policy and there is nothing the expected buyer can do about that. The hypothetical buyer can infer expectations about the future from past performance, but uncertainty remains.
3. A's and B's (and D's) self-interests might run counter to the interests of the hypothetical willing buyer, a fact that creates additional uncertainty.
4. The expected return on the $10 million securities portfolio is 8.0%.
5. Interviews with A and B indicate that, like in the past, the partnership is expected to pay a quarterly distribution at an annual rate of 2.5%.
6. Expected appreciation of the portfolio is therefore 5.5% (8.0% - 2.5%).

7. A 33% interest in a partnership with marketable securities is being acquired, and its pro rata share of net asset value is $3.3 million (minimum value). Whether the price is net asset value of $3.3 million or a discounted price, the ultimate price requires investors of substantial net worth. No rational hypothetical or real investor would tie up $2.0 million or $3.3 million in such an investment without having substantial assets such that this asset would be a small part of a diversified portfolio of assets. The size of the interest limits the potential market to wealthy individuals or institutions who we can assume have sophistication to analyze the economics of this investment. The bottom line is that the market for the 33% interest in Limited Partnership X is quite limited and sophisticated.

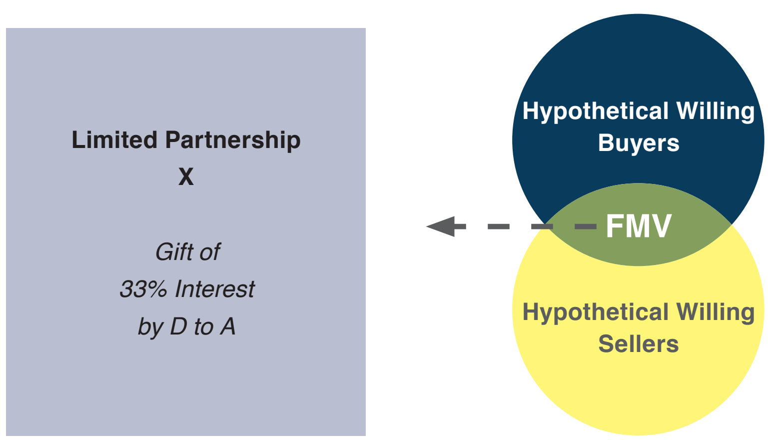
8. There is one exception to the "normal" terms above. The hypothetical willing buyer would have a **hypothetical put** to the partnership calling for liquidation of the interest at minimum value, or net asset value. The economic effect of this put (for cash or property within six months) is intended to effectively eliminate minority interest and marketability discounts.

## What is Fair Market Value?

The definition of fair market value (from Revenue Ruling 59-60) is partially quoted in discussing the value of notes issued by operating companies in the Proposed Changes, and not when valuing partnership interests. The definition of fair market value in the **ASA Business Valuation Standards** follows:

> The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Fair market value presumes that there are hypothetical willing buyers and hypothetical willing sellers. They are able, or have the financial capacity, to engage in hypothetical transactions. They are equally knowledgeable about the risks and benefits of a proposed investment, i.e., about the relevant facts. The market they are acting in is open and unrestricted, even if private. Neither the hypothetical willing buyer nor the hypothetical willing seller is acting under any compulsion. Fair Market Value occurs at the intersection of hypothetical willing buyers and hypothetical willing sellers.



In the context of the example of Limited Partnership X, appraisers are to determine the fair market value, as defined above, of the 33% limited partnership interest. Fair market value occurs at the intersection of hypothetical negotiations between hypothetical willing buyers and hypothetical willing sellers, as seen conceptually in the figure at the bottom of page 10.

Keep the definition of fair market value and the explanatory comments in mind as we look at an example provided in the Proposed Changes and as amended for this discussion.

# Fair Market Value Method 1

We include the assumptions above as among the factors influencing fair market value, all of which will be considered by hypothetical willing buyers and sellers in their hypothetical negotiations. Consider two ways to examine valuation in accordance with the Proposed Changes. Some readers of the Proposed Changes, and likely the drafters, think that fair market value would be determined in two straightforward steps.

1. **Determine the minimum value of Limited Partnership X**. Minimum value of the partnership is determined by taking the fair market values of all of the securities in its portfolio, which we assume to be $10 million. Subtract liabilities, and there are none, so minimum value, or net asset value, is $10 million. The actual wording of the definition of minimum value suggests that, under the Proposed Changes, contingent but real liabilities like embedded capital gains liabilities in C corporations are excluded from minimum value calculations.

2. **Determine the fair market value of the 33% interest**. Under this method, the put right assumed to be transferred to the hypothetical willing buyer is thought to eliminate any discount for lack of control (the interest controls liquidation) and any marketability discount (since the partnership is the presumed market at minimum value). The "fair market value" is determined to be $3.3 million ($10 million x 33%).

The problem is, this method **does not determine the fair market value of the 33% interest**, because it did not consider all the factors outlined above. This first method effectively assumes that the family partnership (i.e., Limited Partnership X in this instance) does not exist for valuation purposes. It also assumes, as do the Proposed Changes, that the business purpose of the partnership is irrelevant. How can the business purpose have relevance if any partner can demand liquidation of his or her interest at any time?

The hypothetical willing buyer of fair market value did not show up for the hypothetical negotiation with the hypothetical willing seller. The hypothetical seller is pleased with the conclusion of $3.3 million because in the hypothetical transaction he or she gets $3.3 million in cash or property quickly. However, as we will see below, no rational hypothetical willing buyer would pay $3.3 million for the 33% interest, even with a put.

The overriding purpose of the Proposed Changes is to eliminate valuation discounts. It is therefore interesting that the Proposed Changes document includes neither of the terms "minority interest discount" or "marketability discount" (or any variations of these names). In addition, the only mention of hypothetical buyers and sellers is found in the partial quote of the definition of fair market value in connection with the discussion of the valuation of notes that might be issued by operating businesses in certain circumstances.

## Fair Market Value Method 2

We now turn to a second method to determine fair market value. It is actually the method called for by the guidance above from Proposed 2704-3(g). In this method, appraisers apply generally accepted valuation principles and consider all factors that are important regarding the asset from the perspective of hypothetical willing buyers and sellers.

We provided a general list of factors for Limited Partnership X above. We incorporate them and then provide a fairly typical analysis of them and other typical investment factors below.

What are some of the considerations or questions that hypothetical willing buyers might think important in negotiating to purchase the 33% interest in Limited Partnership X from a hypothetical willing seller?

1. In acquiring the 33% interest, the hypothetical willing buyer would have to desire or be satisfied with the exact portfolio as configured by A and B as general partners. If the hypothetical buyer wanted this portfolio, he could reconstruct it on his own and have control over the assets. He will not have control over the assets once he acquires the 33% interest in Limited Partnership X. The hypothetical seller would have to make some concession for this fact.

2. Would the hypothetical willing buyer be satisfied with the management abilities and decisions of A and B and their expected distribution policy? At the very least, their control of the partnership creates uncertainty for a new 33% limited partner, which requires compensation.

3. The hypothetical willing buyer would recognize that NAV (minimum value) does not include costs of liquidating the partnership or portions of it. He might have concerns over future pushback from the partnership as a result. This would be particularly true in the event of a total liquidation, where if he received minimum value, other partners would have to receive less than minimum value.

4. The hypothetical buyer would recognize that, even if an effective put existed for his interest after the hypothetical purchase, the value of the 33% interest is at risk. One thing this author knows from nearly 40 years in business is that surprises in liquidation are almost always negative. The hypothetical buyer would demand some compensation for this risk.

5. The hypothetical willing buyer would also know that the 33% interest represents a significant investment in the context of his overall portfolio. The hypothetical buyer would be a quite wealthy individual or an institution of some kind perhaps, although the interest is not really of institutional quality.

6. Minimum value (net asset value) is $3.3 million. There would be no reason to invest in the partnership and tie up valuable resources without some incremental return expectation, even with a put, which, as we see, has some uncertainty attached to it. That increment in return would come from an increase in the required holding period return above the 8.0% expected return of Limited Partnership X.

7. The hypothetical buyer would recognize that if he exercised his put, it would be in the best interests of remaining partners to wait to pay for the full six months provided by the hypothetical put. He would demand some compensation for the wait, as well as for the risks assumed as result of the wait. The put does not solve all problems.

8. The hypothetical willing buyer **would not pay net asset value for the 33% interest** of Limited Partnership X, even with a put right at minimum value. It is not economic to assume that he would pay minimum value, immediately put the interest, and hope to get his money back in six months.

9. The hypothetical willing buyer would consider all these things and **determine how much of a valuation discount would be required** to induce him to purchase the interest.

10. The hypothetical willing seller, who is rational, capable and knowledgeable, would recognize the value-reducing impact of the factors we have focused on above and negotiate for the best price possible, which we know is not minimum value.

The appraiser's job is to simulate the hypothetical negotiations outlined above and to estimate or quantify the extent of the required valuation discount. Note that we have not mentioned minority interest discounts or marketability discounts. Reference to control premium or other studies regarding minority interest discounts are irrelevant in this world of the Proposed Changes. Reference to restricted stock studies is also irrelevant. No buyers in the transactions analyzed in the restricted stock studies have a put at minimum value or at any value.

In the world of the Proposed Changes, appraisers will have to analyze the economics of each particular family partnership and the economics of each interest. They will have to analyze the extent that the assumed put at minimum value might impact value. And they will have to make assumptions about the specific economics (risks and cash flows) of each interest being valued. Based on our initial review, this analysis will best be done quantitatively, at least in part. Of course there will qualitative considerations, as well.

## Additional Considerations Regarding Fair Market Value of Family Partnerships

It should be clear from the analysis of Fair Market Value Method 2 that the **conclusion of Method 1 does not represent fair market value**. The conclusion of Method 1 (minimum value) provides unwarranted enrichment for the hypothetical willing seller and uncompensated expected risks for the hypothetical. That result does not satisfy the requirements of the definition of fair market value because it is not a price at which buyers and sellers would agree.

All of the factors noted above exist for Limited Partnership X, which is a securities-only family partnership. It should be clear that when we consider all these factors, a fair market value determination of the 33% interest described above would require some discount, and perhaps a significant discount, to induce a rational hypothetical or real purchaser to make the investment.

The issues are exacerbated when we move from securities-only to less liquid or illiquid assets in family partnerships. A few initial thoughts include considerations for these asset classes:

- **Income-producing property.** Assume the sole asset in a family partnership is an apartment building with a market value of $10 million. All other facts remain the same as with Limited Partnership X. The hypothetical willing buyer is given a put for cash at minimum value ($3.3 million). What will he think about the value of the put when the only way he can exercise it is for the general partners to sell the entire building. They are precluded from providing a note, which might be possible given the lack of leverage. How long would it take to sell the apartment building in the ordinary course of business to achieve market value? Whatever the ultimate discount negotiated for the 33% limited partner interest in Limited Partnership X, it would be higher than for another partnership holding a $10 million income-producing property.

  If the exercise of the put by the hypothetical buyer forces a sale of the property, the net proceeds of the sale will be less than minimum value, which we assume for simplicity is $10 million, and minimum value for the 33% put exercise is $3.3 million. Assume expenses of sale are 5%, or $0.5 million. Net proceeds are therefore only $9.5 million. If the partner exercising the put receives $3.3 million, remaining proceeds are only $6.2 million to be shared by the remaining partners, or less than their pro rata share of minimum value, or $6.7 million. In real life, partners would never agree to such a put that provides an incentive to exercise in spite of the long-term business objective of owning the income producing property.

- **Raw land well outside a city border.** This partnership was created to hold raw land and to wait for the growth of the city to overtake it in a few years. It has not happened yet, and if things go well, it will take a number of years for development to begin to reach the property. The property's market value is $10 million. Value is assumed to be growing at about 8% per year, but there is, of course, no expected distribution. Hypothetical buyers would ignore the six month expectation of cash and would hardly appreciate payment in the form of a portion of the property. The hypothetical buyer would think that if he ever exercised the put, it could take a quite long time for the partnership to sell the land and provide minimum value. Consider that we have replicated our comments regarding expenses of sale here. The hypothetical buyer would require a premium in return, and therefore, a lower value than minimum value of $10 million.

- **An operating business.** The business is a profitable distribution company with pre-tax earnings $2.0 million per year. It is valued at five times earnings, or $10 million. Growth and distribution yield characteristics are similar to Limited Partnership X. Again, the put option would not have material value in the eyes of hypothetical buyers. The company might or might not be able to issue a note for the put exercise, depending on its leverage and performance at the time. If it could issue a note, that would not represent the form of investment that the investor is seeking. And cash in six months is problematic when it comes to selling operating businesses. It can take 1-2 years or more to sell on relatively favorable terms, and often longer. There is no provision in the put right for expense sharing on sale. Further, there is an argument that, because the operating company is subject to a put by all partners, the overall financial risk of the company itself is increased. If so, the put right would have a negative impact on minimum value (appraised value) and the put right would have a negative impact on value. The hypothetical willing buyer would require a premium in return, and therefore a lower value than the minimum value of $10 million.

In each of the above examples, minimum value of $10 million would not be indicative of fair market value when applied to a 33% interest.  The partnerships do exist and do have business purposes.

## Conclusions

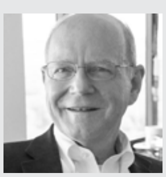
The Proposed Changes to Section 2704 appear to be designed to eliminate the use of minority interest and marketability discounts in fair market value determinations of illiquid, minority interests in family limited partnerships (and C corporations and S corporations and limited liability companies).

They do so by assuming that there is a presumed (hypothetical) liquidation of limited partnership interests being transferred, with the presumed liquidation being at minimum value, or net asset value.

All family member partners are presumed to vote in favor of eliminating restrictions on transfer, and to clear a path towards hypothetical liquidations.

*The problem with the Proposed Changes is that they fail to realize that even with no restrictions on transfer, and if all applicable restrictions are ignored and we consider all of the named disregarded restrictions, appraisers are left with illiquid minority interests in family partnerships that have investment characteristics that still require analysis to determine fair market value.*

This paper made certain fairly typical assumptions so that we could dig into the valuation dynamics implied by the example of Limited Partnership X and three other partnerships.  We disregarded what we were instructed to disregard and still developed, under the named assumptions, a discount by whatever name is appropriate.  Appraisers will have to determine what that is based on their fair market value determinations and their consideration of all relevant factors pertaining to subject interests.



## About the Author

**Z. Christopher Mercer, FASA, CFA, ABAR** is the founder and chief executive officer of Mercer Capital. With nearly 40 years of business valuation experience, he has prepared, overseen, or contributed to hundreds of valuations for purposes related to tax, ESOPs, buy-sell agreements, and litigation, among others.

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