

Astleford v. Commissioner

Tier Discounts Allowed; Substantial Lack of Control and Marketability
Discounts Recognized for Parent and Subsidiary Real Estate
Partnerships, *Astleford v. Commissioner*, T.C. Memo. 2008-128

May 2008
Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Synopsis:

This gift tax case allows lack of control and marketability discounts for tiered partnership interests. An FLP owned a 50% interest in a real estate general partnership and various other real estate tracts. An approximate 20% absorption discount was allowed for valuing a 1,187 acre tract in the general partnership. The FLP's 50% interest in the general partnership was valued as a partnership interest rather than as an assignee interest. Even so, a 30% combined discount for lack of control and marketability was allowed for the 50% interest in the general partnership. An approximate 17% lack of control and 22% lack of marketability discount (for a seriatim discount of about 35%) was allowed for valuing gifts of 90% of the limited partnership interests (three 30% gifts in 1996 and 1997).

Basic Facts:

1. Mr. Astleford owned a 50% interest in a real estate general partnership that, among other things, owned a 1,187 acre tract of farmland.
2. Mr. Astleford died in 1995 and left his 50% interest in the real estate general partnership and a number of other real estate properties to a Marital Trust for Mrs. Astleford.
3. In 1996, Mrs. Astleford formed an FLP with her interest in an assisted living facility, and simultaneously made gifts of 30% limited partnership interests to each of her three children, retaining the 10% general partnership interest in the FLP. [The purpose of the FLP does not seem particularly relevant in this case that does not involve §2036, but the purposes were to facilitate the continued ownership, development, and management of the real estate investments and to facilitate gifts.] Terms of the FLP that might potentially affect value of the limited partnership interest gifts are that the agreement required the annual distribution of net cash flow, limited partners could not vote on management matters, and without the general partner's consent, no outside party could become a partner, a limited partner could not sell its interest, and real property in the partnership could not be partitioned.
4. In 1997, Mrs. Astleford contributed her "entire right and interest" in the 50% interest in the real estate general partnership (the opinion does not indicate how she came to own that interest rather than the Marital Trust) together with 14 other real estate properties that she owned. This increased her percentage interest in the partnership, and Mrs. Astleford simultaneously made additional limited partnership gifts to her three children to bring her general partnership percentage interest in the FLP back down to 10%. (The opinion does not indicate how the parties documented the transaction or treated the values and the capital accounts in the contribution and subsequent gifts of limited partnership interests.)

5. Mrs. Astleford filed gift tax returns for 1996 and 1997, reporting gifts of \$277,441 and \$3,954,506, respectively. The IRS audit asserted values of \$626,898 and \$10,937,268, respectively. (The court eventually ended up at values of \$517,575 and \$6,565,215, respectively.)

Analysis:

1. Value and Absorption Discount for 1,187 Acre Tract. The taxpayer's expert applied a value of \$3,100 per acre and contended that a 41.3% absorption discount should apply in valuing the 1,187 acre tract because a sale of the entire tract would flood the local market for farmland. The taxpayer's expert assumed that the land would sell over four years, would appreciate at 7% per year, and that a 25% present value discount rate was appropriate (based on the return on equity rate expected by real estate developers). The IRS's expert valued the tract at \$3,500 per acre and maintained that no absorption discount should be applied.

As to the per acre value, the court said that the IRS's expert "was particularly credible and highly experienced and possessed a unique knowledge of property located throughout Dakota County and the surrounding area," and the court accepted the IRS's \$3,500 per acre value.

As to the absorption discount, the court cited three prior cases that allowed an absorption discount in valuing large parcels of real estate where a sale over a short period of time would reduce the value. Because of the size of the 1,187 acre tract in relation to the number of acres sold each year in that county, the court believed that it was unlikely that all of the property could be sold in one year without a price discount. The court used the taxpayer's assumption that the tract would sell over four years, but reduced the present value discount rate from 25% to 10%, which is close to the return on equity that farmers actually earned in the locality. "A present value discount rate is a function of the riskiness of a project, and the hypothetical project herein is not land development but the sale of farmland over four years." The court observed that there was a low level of risk because 75% of the property had been leased, providing a source of income to a prospective purchaser.

The case ended up applying an absorption discount of slightly over 20% (20.396% to be precise).

2. Value as Partnership Interest, Not Assignee Interest. The taxpayer treated the 50% interest in the general partnership that was owned by the FLP as an assignee interest, because the other 50% partner (who was not a family member) never consented to the transfer to the FLP. The court agreed with the IRS that the substance over form doctrine applies to gift and estate taxes (citing Haven v. United States, 945

F.2d 359, 363 (10th Cir. 1991) and Estate of Murphy v. Commissioner, T.C. Memo. 1990-472). The court believed that in substance the transferred interest should be treated as a partnership interest, not an assignee interest, for two reasons. First, the donor was the sole general partner of the FLP and therefore held all management rights either by retaining the management rights individually if an assignee interest were transferred to the FLP or by holding the management rights as the sole general partner of the FLP if a partnership interest were transferred to the FLP. Second, the documentation suggested the transfer of a full partnership interest because a resolution of the FLP acknowledged receiving all of the donor's rights and interests in the general partnership. (The court cited three other cases that valued FLP interest transfers as partnership interests, not assignee interests, based on the documentation [Estate of Jones, Kerr, and Estate of Dailey], and one case that valued the interest as an assignee interest where the documentation did not indicate that a partnership interest was transferred [Estate of Nowell].)

The IRS argued in the alternative that if the transfer were treated as a mere assignee interest, §2704(a) would apply to treat the difference in value between a partnership interest and an assignee interest as a deemed gift. The court did not have to address that argument in light of its refusal to treat the interest as an assignee interest.

3. Tier Level Multiple Discounts. The IRS's expert did not apply a discount in valuing the 50% general partnership interest, reasoning that applying discounts at the FLP level obviated the need for discounts at the general partnership level. Footnote 5 of the opinion cites four Tax Court and Tax Court memorandum cases that have allowed multi-level discounts where there were minority interests in both levels. (Estate of Piper, Janda, Gow, and Gallun.) However, cases have refused to apply multi-level discounts where minority interests in subsidiaries were a significant portion of the parent entity's assets (Martin) or was the parent's "principal operating subsidiary" (Estate of O'Connell). After the court noted that the 50% general partnership interest was only 16% of the FLP's value and only 1 of 15 real estate investments that the FLP owned, it concluded that lack of control and marketability discounts at both the subsidiary level (i.e., the 50% general partnership interest) and the parent level (i.e., the FLP) were appropriate.

4. Lack of Control and Lack of Marketability Discount.

RELP vs. REIT Comparables. The taxpayer's expert relied on comparability data from sales of registered real estate limited partnerships (or RELPs). The IRS's expert used comparability data from real estate investment trusts (or REITs). The court refused to recognize one set of data as always being superior to the other, noting that the RELPs more closely resemble the partnership interests being valued (and finding that the low trading volume of RELPs on the

secondary market is not so low as to render the data unreliable), but observing that the large number of REIT transactions tends to produce more reliable data and that the differences between REITs and the partnership interests being valued can be minimized given the large number of REITs from which to choose comparables. The court ended up using RELP data for valuing the 50% general partnership interest and REIT data in valuing the FLP interests (as discussed below).

50% General Partnership Interest. After eliminating comparables from two years after the valuation date (i.e., 1997), the court observed that the median and mean trading discounts of the RELPs cited by the taxpayer's expert were 30% and 36%. A total sample of 130 RELPs in 1997 had median and mean trading discounts of 28.7% and 30%, respectively. The court applied a combined 30% discount for lack of control and marketability.

Gifts of FLP Interests; Lack of Control Discount. The taxpayer's expert (and the court) did not just apply the same RELP analysis to determine a similar combined lack of control and marketability discount for the FLP, but instead analyzed the lack of control and lack of marketability discounts separately. To determine the lack of control discount for the FLP interest gifts, the taxpayer's expert selected nine (which it further narrowed to four) RELP comparables, which the court rejected because they were substantially more leveraged than the FLP, and because they reflected a lower cash distribution rate than the FLP. The court used a sliding scale approach: "Where the comparables are relatively few in number, we look for a greater similarity between comparables and the subject property" (citing Estate of Heck). In addition to the leverage difference, the court acknowledged the taxpayer's expert's comment that higher cash distribution rates suggest lower investor risk and therefore lower trading discounts. The FLP's cash distribution rate (10%) was significantly higher than the 6.7% average distribution rate for the comparables.

After rejecting the taxpayer's RELP comparables (which reflected trading discounts of 40-45%), the court used the IRS's expert's REIT data. This was more complicated. The REIT comparables traded at a very slight difference to net asset value in 1996 and 1997 (0.1% premium and a 1.2% discount, respectively). However, the court observed that at least two factors are at work, because REITs allow investors to own a minority but at the same time a liquid investment in an otherwise nonliquid asset (e.g., real estate). One factor is positive (the liquidity premium) and the other is negative (lack of control). Therefore, the court tried to identify and reverse out the liquidity premiums associated with the REIT comparables. (Easier said than done.) The IRS's expert applied a regression analysis to determine that the 1996 and 1997 comparables reflected liquidity premiums of 7.79%. When reversed from the overall slight premium/discounts paid for REITs in 1996 and 1997, this produced lack

of control discounts of 7.14% and 8.34% in 1996 and 1997. The court agreed with the general approach, but observed that the liquidity premiums reflected by the expert's regression analysis was about half that recognized in other studies that the expert had cited. Furthermore, the court said that the 7.79% liquidity premium resulted in a lack of control discount that "on its face appears unreasonably low."

To determine the appropriate liquidity premium to apply to the REIT overall trading premiums, the court looked "simply" [is any of this simple???] to the difference in average discounts in private placements of registered and unregistered stock. It reasoned that the difference represents pure liquidity concerns, since a ready, public market is available to owners of registered stock but not to owners of unregistered stock. The court cites the same approach being used in McCord and Lappo. Using that data, the IRS's expert cited two studies of the registered/unregistered stock data reflecting liquidity premiums of 16.27% that would also be applicable to publicly traded REITs. Using this number as the liquidity premium, the court adjusted the overall small premium/discounts paid for REITs in 1996 and 1997 to reflect lack of control discounts of 16.17% and 17.47% in 1996 and 1997, respectively.

Gifts of FLP Interests; Lack of Marketability Discounts. The IRS's expert's lack of marketability discount (21.23%) was somewhat higher than the taxpayer's expert's estimate (15%), so the court used the IRS's expert's higher number in arriving at a 22% marketability discount. (The court's calculation actually applied a 21.23% marketability discount in 1996 and a 22.0% marketability discount in 1997.)

Gifts of FLP Interests; 35% Combined Lack of Control and Marketability Discount. The lack of control discount was about 17% in the two years, reflecting a discounted value of 83%. A further 22% marketability discount resulted in a combined discounted value of the limited partnership interests of about 83% (i.e., 100% - 17%) times 78% (i.e., 100%-22%), or 64.7%. Therefore, the combined discount is about 35% for gifts of limited partnership interests in the real estate FLP. (It is actually a combined discount of 33.96% in 1996 and 35.63% in 1997.)

Observations:

1. Substantial Discounts Apply. This case is a continuation of the almost uniform trend of cases that allow substantial discounts for FLP interests. While the IRS has won a number of §2036 cases (that have typically involved pretty egregious fact situations), when courts address the amount of discount for FLP interests, they almost always allow substantial discounts. This case allowed about a 35% discount to value limited partnership gifts in an FLP that owns almost entirely real estate assets.

Furthermore, as to an interest in a *general* partnership, in which an owner held a 50% interest, the court allowed a 30% combined lack of control and marketability discount.

As to the portion of the FLP represented by an interest in a general partnership within the FLP, the overall discount was about 55% (i.e., the value was $70\% \times 82.53\% \times 78\%$, or 45.06%, representing an overall 54.93% discount].)

As to the portion of the FLP represented by the 1,187 acre tract, there were three levels of discounts (including the absorption discount) for a combined discount of about 64%. (The actual value was $79.604\% \times 70\% \times 82.53\% \times 78\%$, or 35.87%, representing an overall 64.13% discount.)

2. Multi-Level Tiered Discounts. The court allowed full lack of control and marketability discounts at both the subsidiary level and the parent level. The cases cited by the court suggest that this is appropriate when there are minority interests being valued at both levels. One wonders whether there would be some limit to this approach if there are many subsidiary levels. For example, what if there were 10 subsidiary levels, each of which held minority interests? Would 10 levels of full discounts be applied? Or at some point, is lack of control really a total lack of control without any further "degrees" of lack of control, so that there would no longer be higher and higher levels of discounts for greater "degrees" of lack of control?
3. Absorption Discount Analysis Approach. The court reasons that it is appropriate to apply an absorption discount (for stock, this is often referred to as a blockage discount) if the tract is so large, compared with other sales in the locale, that selling the entire tract in one year would likely require a price reduction. The taxpayer's expert's 41.3% absorption discount was reduced by the court to about 20%, still a significant discount. The primary factors in determining the discount are the length of time to sell the tracts, the assumed income from the property and sale prices in the future years, and the rate for determining the present values of those future cash inflows. To determine the relevant discounting factor, the court said to use a return on equity rate that is expected by investors in a comparable market, considering the risks inherent in the delayed sales of the tracts.
4. Lack of Control Discount. The analysis seems somewhat convoluted, and far from looking "simply" at anything. However, the approach follows the lead of the McCord and Lappo decisions. Follow the bouncing ball. First, look to the taxpayer's RELP (i.e., real estate partnerships) data (suggesting a 40% discount), but the comparables are not similar enough. Next, look to the IRS's REIT (also real estate) data, but the data initially suggests no lack of control discount (because there was very little premium or discount from net asset value in sales of REIT interests for the years in question). The court reasons that this is

because in addition to a lack of control discount there is a liquidity premium associated with the ability to own a liquid interest in a nonliquid asset. How to adjust for that factor? The court looks to stock (NOT real estate) data (sales of registered vs. unregistered stock), which interestingly was also based on data presented by the IRS's expert. The ball finally stops bouncing after arriving at a control discount of about 17%.

At best, this seems to be a rather convoluted approach. Stock data reflecting the value differences for registered and nonregistered stock reflects something closely akin to a lack of marketability factor. The difference in what someone is willing to pay for registered vs. unregistered stock is largely because the investor can turn around and sell the registered stock on an established market immediately, whereas the investor cannot do that with unregistered stock. (It would seem that another important factor is that the SEC rules on disclosure including Sarbanes/Oxley provide additional comfort regarding financial disclosure that might be another reason for part of the premium for registered vs. unregistered stock.) In effect, data reflecting a lack of marketability discount for stock is used to back into a lack of control discount for real estate.

It seems that the experts and courts search for a rationale to *justify* what seems like a bottom line reasonable result, even if the rationale may not seem to be directly related just to a lack of control discount. (Indeed, when one approach produced a result that "on its fact appears unreasonably low," the court in Astleford knew that it was time to use a different approach.)

5. Tiered Ownership Often Makes Business Sense As Well As Potentially Resulting in Larger Discounts. Multi-level entities are often used with real estate properties (to insulate each separate real estate investment from liabilities associated with other real estate investments). This kind of master limited partnership approach can achieve sound business purposes as well as affording significant multi-level discounts in appropriate circumstances. However, the court in Astleford did not address a situation where the "master" partnership owns all or most of the interests in the subsidiary entities. (However, it did not focus on the fact that the FLP owned a minority interest in the subsidiary [in this case it held a 50% interest in the general partnership], but rather on the fact that the subsidiary was only 16% of the parent's net asset value and was just 1 of 15 real estate investments. That same reasoning would apply to many real estate "master" limited partnerships that own a number of separate real estate limited sub-partnerships or LLCs.)
6. No Application of Indirect Gift Approach to Subsequent Funding. When Mrs. Astleford made additional contributions to the FLP in 1997, the court did not treat her as making indirect gifts of the additional contributions directly to her three daughters who already owned the

90% limited partnership interests. The IRS has made that "indirect gift" argument in other cases (for example, Shepherd and Senda). The opinion does not suggest that the IRS made the indirect gift argument in this case. In any event, the court treated the donor as receiving additional general partnership interests in return for her additional contributions, and simultaneously making gifts of the limited partnership interests to reduce her general partnership interest back down to the 10% level that she owned before the additional contributions were made. The court does not describe how the 1997 contribution transaction was documented.

Copyright © 2008 Bessemer Trust Company, N.A. All rights reserved.