

# Trusts & Estates

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## Committee Report: Valuations

By William H. Frazier

### Valuation Discounts in Tiered Investments

Does the additional layer add new risks to the market value analysis?

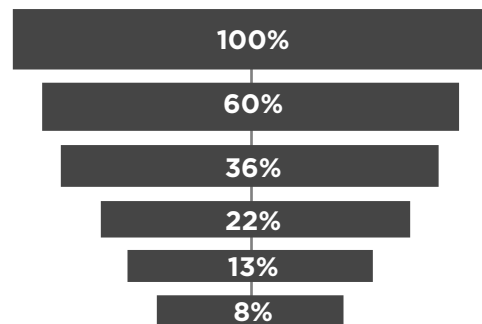
**T**he subject of tiered discounts is a controversial one. Taxpayers may view the application of a tiered discount as a means to achieve a better tax result. Those who are already critical of valuation discounts see the additional layer of discounts as a blatant tax device. In reality, there are times when such discounts are warranted and can be verified by similar constructs existing in the marketplace. There are other times when such discounts are, indeed, excessive and unjustifiable.

If merely adding a tier or layer to a business organization was the only justification for discounts, then sharp estate planners could quickly dissipate any potential transfer tax liability by simply adding a layer or two to their planning. “Disappearing Value,” this page, illustrates the disappearance of value assuming a combined 40 percent discount at each tier.

Many legitimate business purposes exist for the use of complex organizational structures that are unrelated to valuation. A complex structure that serves a necessary operating, fiduciary or governance-related function doesn’t necessarily mandate any additional discounting. The question of discounts from a valuation standpoint is whether the additional layer adds any new risk to the market value analysis. For the most part, the risks we refer to are those due to lack of control and lack of marketability. A limited partnership interest in a family limited partnership (FLP), for example, already suffers from these risks and its value

#### Disappearing Value

*Adding a new layer to a business organization dissipates transfer tax liability*



Note: Assumes a combined 40 percent discount at each tier

— William H. Frazier

is already determined with these risks in mind. Does the addition of another layer really add any new or marginal risk to the valuation equation?

#### Tiered Discounts Rationale

To approach the subject of tiered discounts, a basic understanding of the rationale for discounts is appropriate. A discount is merely the fraction that results when one compares two numerical values and expresses the difference between the two as a function of the larger number. The resulting differential is referred to as the discount. In the context of business valuation, the two numbers are respectively, net asset value (NAV) and an estimate of fair market value (FMV). In most cases,



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FMV is less than NAV. This is because NAV relates to a pro rata ownership of assets held by the partnership, while FMV relates to an equitable ownership of partnership units, not partnership assets. The fractional ownership of partnership units bears comparatively more risk than does a comparable pro rata ownership of assets. The expected economic return of the assets is the source of the value of partnership. The conversion or transfer of these economic returns to the owner of an equity interest isn't certain. The twin risks of lack of control and lack of marketability require that holders of equity interests seek a higher rate of return than would holders of the underlying assets. Mathematically, a higher discount rate applied to the same economic return results in a lower value. The resulting differential is referred to as the discount.

It's important to realize that the discount isn't an entity, a commodity or a "thing" in its own right, but merely a mathematical comparison of two separate concepts of value. The discount isn't "selected," but "determined" by a process that considers risk and reward in the context of alternative investments available in the marketplace.

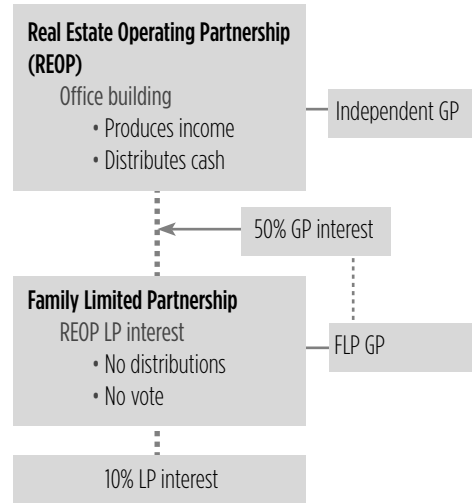
If this is so, then the discount doesn't exist because of a legal structure or design but because of the operation of economic forces that can be objectively demonstrated within a particular business construct. It's not the complexity of the construct that gives rise to valuation differences but the existence of identifiable and measurable risk factors.

### Components

"Tiered Entity Valuation Components," this page, describes an FLP whose only investment is a general partnership (GP) interest in a real estate operating partnership (REOP). The limited partner (LP) holds an equity interest in the FLP. The GP interest isn't worth 50 percent of the NAV of the REOP since it's subject to discounts for both lack of control and marketability. However, due to the relative power of the GP interest and the existence of distributions, the discounts may not be very great. The LP, however, is subject to a much higher degree of lack of control. The GP of the FLP is different and unrelated to the GP of the REOP with respect to the 50 percent GP interest not held by the FLP. The FLP governance, information reporting and nature

### Tiered Entity Valuation Components

*Different asset classes, control and distributions mean a greater illiquidity impediment for the LP*



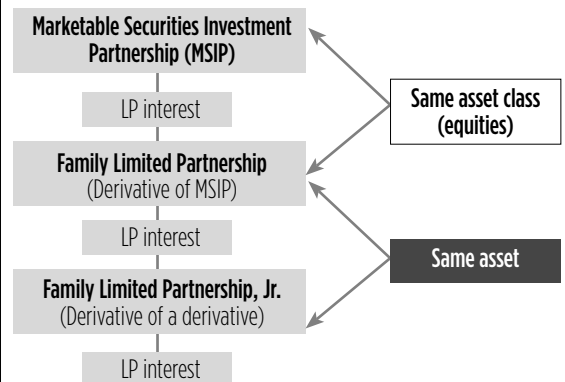
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of the investment (minority LP versus 50 percent GP) are vastly different. The LP suffers from a far greater illiquidity impediment—especially because no distributions are being made.

The contrary example is seen in "Two Many Tiers," this page. Here, the layer holding the investments (the asset tier) is a limited partnership. The second tier owns only an interest in the asset tier. Thus, the LP of the

### Two Many Tiers

*No new risks are presented at the LP level, so no discounts are justifiable*



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investment tier holds an equity interest that's an indirect interest in the investment tier's indirect ownership of the asset tier's securities portfolio. Furthermore, the same GP manages both partnerships. In short, there are no discernable new risks present at the LP level of the investment tier relative to the pro rata NAV of the investment tier (the FMV of a minority LP interest in the asset tier). No discounts from the investment tier partnership NAV appear justifiable in valuing the underlying LP interests.

### Two Closed-End Funds

A way to illustrate this principle is seen in an examination of two closed-end funds—Equus Total Return, Inc. (Equus) and Cohen & Steers Closed-End Opportunity Fund, Inc. (Cohen & Steers). The two funds both exhibit a tiered structure. One trades at a deep discount from underlying NAV while the other trades at nearly no discount.

Equus, which is a long surviving closed-end fund, commonly trades at around 40 percent below NAV. The fund invests in venture capital (VC). It also invests in other funds that, in turn, invest in VC situations. Its 2010 Form 10-K annual filing with the Securities and Exchange Commission states: "Investments in small capitalization companies present certain risks that may not exist to the same degree as investments in larger, more established companies and will cause such investments to be volatile and speculative." In addition to these risks, the fund also makes it known that it doesn't necessarily diversify its investments. In fact, it's classified as a "non-diversified" investment company under the 1940 Investment Company Act. Another issue with respect to Equus is that its compensation is structured like a private equity fund. After a certain threshold is reached, management participates in the profits with the investors.

Because Equus doesn't invest directly in many of its investments, it relies on others to provide it with information as to subject investments, especially with regard to the NAV of such information. The lack of assurance as to the quality and/or timeliness of such information is a risk directly associated with the tiered structure. As an indirect investor, Equus has no voice in the management of some of its investments. In addition, because of the tiered structure, Equus isn't in the position to sell or liquidate its investments and must

rely upon others to exercise these actions. Some of the investment managers here may not have their economic interests in alignment with Equus.

Cohen & Steers invests in other funds and, thus, has no voice in the portfolio management of these funds. But, here the similarities with Equus cease. First, and foremost, Cohen & Steers' investments are primarily in publicly traded funds, which invest in stocks of New York Stock Exchange companies. Both the shares of Cohen & Steers and the closed-end funds in which it invests are relatively liquid, so it doesn't suffer from illiquidity. The asset valuations of its underlying investments are relatively accurate and not nearly as volatile as the private equity investments of Equus. Its investments are diversified.

Cohen & Steers has recently traded at a discount from NAV in a range of 0 percent to 5 percent. However, it's important to remember here that this fund's NAV is the collective market price of the funds in which it invests. Those market prices, for the most part, already reflect a discount from underlying net asset value of from 5 percent to 10 percent.

So, based upon the foregoing, we can safely say that since tiered discounts do exist in the marketplace, they can certainly be supportable in the valuation of privately held asset investment entities. The question of magnitude is answered by the risks and rewards.

The primary areas of focus in the study of discounts in tiered structures has to do with asset class(es), governance and distributions. The volatility, or risk, of the underlying asset is the starting point for the discounts. Obviously, the higher the volatility, the more important are such secondary factors as managerial skill, information flow and liquidity. The lack of such characteristics leaves the investor exposed to greater financial risk. Accordingly, the investor will demand a higher return driving the bid price down and resulting in a greater discount.

By its very nature, the investment tier is always characterized as an equity investment in a closely held entity. If the asset-holding tier also holds equity securities whose investment risks are accounted for in the initial discount, are there any further asset class risks to consider at the investment tier? Would the application of an additional discount for lack of control at the investment tier represent double counting? Like everything else, it depends.

The equity asset class is a very broad one that includes business entities of all shapes and sizes. Clearly, careful analysis is required here. The two closed-end funds we described earlier illustrate this issue very well. A significant portion of the Equus portfolio is investments in equity interests of partnerships holding speculative, volatile companies. Even though the risks of lack of control are embodied in the NAV determination of each partnership in which Equus invests, we see that the discount of the Equus common stock price and reported NAV is still quite large. Cohen & Steers invests in equity securities of closed-end funds which, in turn, invest in large corporations whose stock is traded on the New York Stock Exchange. Cohen & Steers stock price trades at almost no discount.

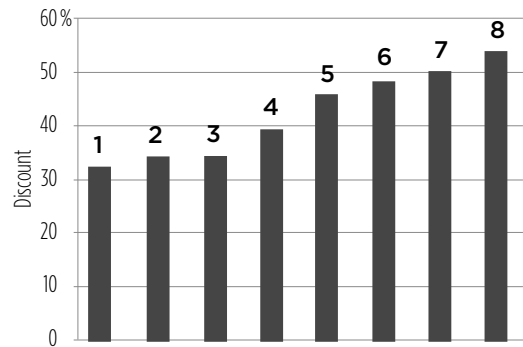
Usually, when the investments held in the asset tier and investment tier are of different asset classes (for example, real estate and equity), the discounts will be additive and, therefore, maximized. However, these considerations can be ameliorated or exacerbated by the governance structure and the presence or lack of distributions.

Whether the general partner (or managing member) is the same at both tiers is a key issue. If the general partner is the same then, usually, one would expect no difference in management quality, investment information and governance policies. Thus, the second tier would ordinarily not be experiencing any marginal increase in this risk factor. Further, the greater the similarity in the governing provisions of the agreements of the two entities, the lower the likelihood for any marginal risk at the next tier.

Distributions are extremely important to the valuation equation. One tier may earn significant cash flow and have a full payout policy. The other tier may make no distributions. If income is “trapped” in the investment entity, the result for the individual LP is a current income tax liability but no cash with which to pay the tax—an unattractive feature to say the least. The receipt of distributions in excess of tax liabilities can materially lower the magnitude of discounts. Closed-end funds with high payout ratios trade at significantly lower discounts from NAV relative to low payout funds. Lack of marketability studies find lower discounts for dividend paying stocks. This makes perfect sense as the mathematical effect of distributions is to shorten the duration or holding period. Remarkably, many Tax

## Tiered Discounts

*Eight configurations of minimum and maximum scenarios with respect to three risk elements: asset class, management and distribution*



Each number 1 through 8 represents a different scenario

Asset Class	Management	Distribution
1 Same asset class	Same general partner	Distributions
2 Same asset class	Different general partner	Distributions
3 Different asset class	Same general partner	Distributions
4 Different asset class	Different general partner	Distributions
5 Same asset class	Same general partner	No distributions
6 Same asset class	Different general partner	No distributions
7 Different asset class	Same general partner	No distributions
8 Different asset class	Different general partner	No distributions

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Court decisions have ignored the effects of distributions and the holding period.

## Three Main Risk Elements

“Tiered Discounts,” this page, illustrates eight basic configurations of minimum and maximum scenarios with respect to the three main risk elements: asset class, management and distributions. Of course, the scenarios could be further subdivided into an infinite number of combinations and the chart doesn’t include all imaginable risks. The purpose of “Tiered Discounts” is to provide my view of the general magnitude of the more frequently observed discount scenarios. Obviously, the chart is for illustrative purposes and isn’t authoritative.

## Overlap Between Discounts

In many situations it’s difficult to allocate the market price/NAV differential (the discount) between lack of control and lack of marketability. Most academics who study this area don’t even attempt to make this distinction. All pricing differential is referred to as a liquidity cost. To financial economists, asymmetrical information, monitoring costs, asset pricing mis-

specification and agency problems all go into a mix of factors that cause the price of equity to be lower than it should theoretically be. The appraisal profession and the courts would describe these elements as “lack of control” factors.

Both the academic community and the appraisal profession use similar terminology with respect to the issues of blockage, trading restrictions and market demand/supply imbalances. Both communities would describe these marketability issues as liquidity costs.

In the final analysis, the issue is one of semantics. It shouldn't really matter how the cost is catalogued as long as it's properly measured and included in the valuation analysis. Nevertheless, confusion does exist.

For example, the magnitude of both the discounts for lack of control and lack of marketability are exacerbated by the volatility of the assets held. Distributions also affect both discounts.

We've described Equus' large discount as a discount for lack of control. However, there can be no question that a significant portion of this discount is related to the illiquidity of the investments it holds. The Equus stock itself isn't considered illiquid since it's publicly-traded. Cohen & Steers stock is liquid. The closed-end funds in which it invests are publicly traded stocks. The investment positions held by these closed-end funds are also highly liquid.

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It shouldn't really matter how the cost is catalogued as long as it's properly measured and included in the valuation analysis.

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Another often seen example of the overlap between the costs of control and illiquidity is in the valuation of partnerships holding real estate. Here appraisers often rely on market transactions occurring in the secondary market for interests in nationally syndicated real estate partnerships. We agree with the general premise of the “2009 Executive Summary Report on Partnership

Resale Discounts” published by Partnership Profiles, Inc., (the 2009 Executive Summary) that most of the discount indicated in the secondary market is related to lack of control, as described in the following statement from the 2009 Executive Summary:

Although it is not possible to precisely quantify the amount of discount attributable to marketability versus lack-of-control considerations, it is the opinion of Partnership Profiles, Inc., along with many appraisers, that most of the overall discount is due to lack-of-control issues. While the partnership secondary market is not a recognized securities exchange, it is a market where there are multiple bidders who stand ready to purchase the units of virtually any publicly registered partnership that has value.... It is typically not a matter of whether the units of a partnership can be sold, but a matter of how long it takes to deliver the net sale proceeds into the hands of the seller.

In a situation where market-pricing information for transactions in comparable investments is used to substantiate a lack of control discount, it's imperative to attempt to measure the degree to which the pricing information is affected by marketability issues. This is because a discount for lack of marketability (DLOM) will be applied in the valuation of the investment tier interest (the subject interest of the valuation). Unless the marketability impact is stripped from the lack of control discount, there will be double counting in the DLOM of the subject interest.

Some have suggested that all pricing discounts are ultimately related to liquidity. The logic is that if the interest being valued was liquid and if the holder of that interest believed his investment was negatively impacted by a factor which we would categorize as a lack of control cost (concerns about management, inadequate information), the investor could “vote with his feet” by selling the interest and reinvesting elsewhere. The fact that these undesirable conditions exist and the investor can't diversify away from them is, thus, a cost of illiquidity and should be part of the DLOM.

This argument's logic is inescapable as long as it's understood that the costs, regardless of what you call them or where you categorize them, will be measured and included. In this sense, you are just going to have

one single (combined) pricing discount based on a variety of issues all housed under the general heading of “illiquidity costs.”

As difficult as it may be to distinguish the causation of the discounts for lack of control and lack of marketability, there’s good reason to maintain the separate identity of these two investment risk categories in the valuation of closely held securities. In the first place, there’s now a lengthy history of judicial precedent, laws and regulations that conceptualize investments and valuation from a perspective of control and marketability. The securities laws and the SEC came into being to protect investors largely because they didn’t have control over any aspect of investing in the public marketplace.

Having perfect liquidity doesn’t protect an investor from the negative consequences of being deprived of important information or being given false or misleading information. Liquidity affords the investor the opportunity to exit but, oftentimes, only after the damage has been done.

### *Astleford v. Commissioner*

The Tax Court case of *Astleford v. Comm’r*<sup>1</sup> provides a unique window into the world of tiered investment entity valuation. In 1970, M. G. Astleford (MG) and another individual formed Pine Bend Development Company as a Minnesota GP. Each owned a 50 percent partnership interest in Pine Bend. In 1995, MG died. His spouse, Jane Astleford, inherited this interest as well as several other real estate assets worth substantially more.

In the 1996, the Astleford Family Limited Partnership (AFLP) was created. On Dec. 1, 1997, as an additional capital contribution to AFLP, Jane transferred to AFLP her 50 percent Pine Bend interest and her ownership interest in 14 other real estate properties. Jane also made substantial gifts of limited partnership interests on this date, the valuations of which the IRS challenged.

The gift tax filing reflected AFLP’s 50 percent interest in the NAV of Pine Bend at \$1,855,687. The NAV of AFLP’s other assets, owned directly, was \$10,032,721. As you can see, the Pine Bend assets are only a small percentage of AFLP’s overall value. Despite the small size of these assets, the reported case provides an excellent discussion and development of the tiered discount applicable to the NAV of the Pine Bend interest.

Under the provisions of the AFLP agreement, the net cash flow was to be distributed annually among the part-

ners. The LPs weren’t entitled to vote except in major circumstances. No outside party could become a partner without the general partner’s consent.

Testimony during the trial revealed that the annual expectation of growth in AFLP’s asset value was 7 percent. In addition, the annual expectation for cash distributions was 10 percent of NAV. (Presumably, these same relationships held for Pine Bend as it was an asset of AFLP.)

The court ruled that the 50 percent interest in Pine Bend was a general partnership interest—not an assignee interest as claimed by the taxpayer. Based on all of the testimony, the court decided that a combined discount of 30 percent was appropriate for the Pine Bend interest. This is the discount at the first tier. The tiered discount is the discount that results after taking into account all discounts intervening between the “top” asset value and the “bottom” limited partnership interest.

The court found that the overall discounts at the AFLP LP level were 17.47 percent for lack of control (minority interest) and 22 percent for lack of marketability. These two discounts, on a combined basis, equate to a discount of 35.6 percent. If AFLP held no assets other than its interest in Pine Bend, the “tiered” discount at the AFLP LP level is 55 percent.

There are several ways to analyze this from the standpoint of the reasonableness of the discount.

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To analyze whether the court’s decision in *Astleford* was reasonable, we consider three primary risk analysis components: asset risk, governance and distributions.

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First, we look at the previous discussion of our anecdotal experience of discounts based on the consideration of the three primary risk analysis components: asset risk, governance and distributions.

With respect to asset risk, Pine Bend was described as holding mature, income producing real estate (1,187 acres of farmland in southeastern Minnesota leased to

farmers). Based on the information reported in the case, it seems appropriate to describe the asset risk as low to moderate. As a frame of reference, the assets appear more risky than government or municipal bonds but no more risky than large cap common stock. In fact, the taxpayer's expert described AFLP as inherently less risky than the real estate investment trust used as comparables. The asset classes are different between the asset tier and the investment tier, so it would appear that some modest, additional discounting for lack of control is appropriate.

In terms of governance, the same individual (Jane) served as a 50 percent general partner of Pine Bend and the sole general partner of AFLP. The relationship with the other Pine Bend GP goes back almost 50 years. The risk from this standpoint is quite low.

The 10 percent distribution rate was highlighted as a highly important valuation factor. This excellent rate of return was superior to all of the comparables. The positive financial attribute argues against significant second tier discounting.

Based on the foregoing and the anecdotal results provided in "The Rationale Behind *Astleford v. Commissioner*," this page, the total discount appropriate for the interest in Pine Bend appears to be within a range of 30 to 40 percent. (See "Summary of Discounts

### The Rationale Behind *Astleford v. Commissioner*

*How the court came to the tiered discount applicable to the net asset value of the Pine Bend interest*

#### What if Pine Bend were the only *Astleford* Family Limited Partnership asset?\*

Pine Bend NAV	\$3,711,734
NAV of 50% GP interest	1,855,867
Less combined 30% discount	(556,760)
Pine Bend 50% GP interest (discounted by 30%)	1,299,107
Less discount for lack of control—17.47%	(226,954)
Marketable minority interest value (MMIV)	1,072,153
Discount for lack of marketability	(235,874)
FMV	836,729
<b>Combined discount</b>	<b>54.9%</b>

\*Valuation as of Dec. 1, 1997

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### Summary of Discounts in *Astleford v. Commissioner*

*After taking into account the discounts applied to the bulk of the AFLP NAV that exist in only one tier, the combined discount of 38.6 percent seems right*

#### Pine Bend GP Interest\*

Pine Bend assets cash	\$213,159
Rosemount property	3,308,575
Stipulated NAV of other property	190,000
Total NAV of Pine Bend	3,711,734
Less 30% combined discount	(1,113,520)
Total discounted Pine Bend NAV	2,598,214

#### AFLP Interest\*

FMV of 50% Pine Bend GP interest	\$1,299,107
NAV of other AFLP property	10,032,271
AFLP NAV	11,331,378
Less discount for lack of control — 17.47% MMIV	(1,979,592)
Marketable minority interest value (MMIV)	9,351,786
Less discount for lack of marketability —22%	(2,057,393)
FMV	7,294,393
Combined discount from AFLP NAV	35.6%
<b>Combined discount including Pine Bend discount</b>	<b>38.6%</b>

\*Valuation as of Dec. 1, 1997

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in *Astleford v. Commissioner*," this page.) The 55 percent discount applied to Pine Bend resulting from both levels of discounts determined seems to be excessive.

Another way to analyze the discount is to gather the financial clues provided in the case and construct an expected rate of return model. Without belaboring this point, I've concluded that an investment in AFLP at the discounted price, if Pine Bend were its only asset, would yield a rate of return in excess of 20 percent. Given the excellent financial parameters of the partnership (not the least of which is the significant current economic return), the derived rate of return is far too high. A willing buyer would pay substantially more than 45 cents on the dollar for an ownership interest in AFLP under our hypothetical scenario.

Despite what we believe is a too large tiered discount, the final discount applied by the *Astleford* court seems appropriate. That is, after taking into account the discounts applied to the bulk of the AFLP NAV, which

exist in only one tier, the weighted average discount (38.6 percent) seems about right.

Using the same economic principles applied in the case, at a price of 61 cents on the dollar, the expected rate of return on investment is in a range of 15 percent to 18 percent. If one were to invest in a diversified portfolio of publicly traded real estate investment trusts, a total return of 12 percent might be expected. Even though the interest in AFLP does receive an attractive annual distribution, the interest is still illiquid and the holder has no voice in management and would receive little or no information from the partnership. These costs could easily equate to the 300-500 basis point differential indicated by the pricing.

I want to mention something. When you're counting the tiered discount situations, most often you're not going to run into a situation where you're valuing a limited partnership interest in a partnership whose only asset is an investment in another partnership. ☐

#### Endnote

1. *Astleford v. Commissioner*, T.C. Memo. 2008-128 (May 5, 2008).



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