ESTATE TAX VALUATION SERIES: FLPs & LLCs

"NOTHING IS CERTAIN BUT DEATH & TAXES"
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AGENDA FOR TODAY

Control vs LACK OF CONTROL

- Introduction
- Levels of Value
- Prerogatives of control
- Degree of Control
- Control/Non-Controlling Value
- Other Factors to Consider
- Empirical Factors
- Conclusion

THE GREAT RESET

- Estate exemption $13.61 million (2024)
- Set to “sunset” and return to 2017 levels
- Expected to go to b/w $6M to $7M
- Marginal Tax Rate @ 40%

INTRODUCTION

FLPs VERSUS LLCs

- FLPs are non-taxable entities created & governed by state statutes.
- General & limited partners made up of family members
- Limited partnership created under and governed by the RULPA of the state in which it was formed
- Each states' RULPA must be reviewed separately as differences exist

- LLCs has a different legal structure with characteristics of a corporation & of a partnership
- Valuation issues resemble that of a family limited partnership
- LLC looks like a partnership in terms of internal structure & relationships b/w members or members & managers
- Additional liability shield from aicarious liability ofr members & managers

FLPS ARE PARTICULARLY ATTRACTIVE AS ESTATE PLANNING TOOLS

- Promote efficient & economic mgmt. of assets & properties under 1 entity
- Parents/Grandparents have the ability to indirectly trsf interests in family-owned assets
  - But maintain the group of assets as a whole
- Protection against creditors can be achieved at a higher degree
- Assets can be kept in the family (restrictions can be imposed on trsfs of FLP interests)
- Problems pertaining to undivided or fractionalized interests when a property is gifted to several individuals can be avoided
- Advantages can arise through economies of scale and diversification
- Partnership & operating agreements can provide flexibility
- FLPs are pass-through entities & do not pay income taxes. Some states impose minimum taxes
- Gifting an ownership interest can be made at a lower value than an interest's pro-rata NAV
- Provide a vehicle for resolution of various disputes & avoid costly litigation
- Can improve family knowledge of/and communication about family assets

INFORMATION NEEDED TO PREPARE FLP/LLC VALUATION

- Partnership agreement or operating agreement
- List of assets initially contributed to the FLP/LLC + documentation about any assets that were contributed after the formation of the FLP/LLC
- Valuations of real estate and other assets held by the FLP/LLC
- Financial statements and/or income tax returns of the FLP/LLC for a reasonable number of years
- General partner's or managing members' anticipated policies regarding distribution or Sec 754 election
- History of distributions made to the owners
- Partnership minutes of past meetings or other documents that give insight into the donor's intent at the time the FLP/LLC was formed

UNDERSTANDING THE AGREEMENT

- Form the foundation for the valuation adjustments used in arriving at FMV of the transferred interest
  - Assist the appraiser define the subject interest & the rights associated with it
- Legal interpretations often exist and require input from legal counsel
- Some provisions that give rise to valuation adjustments include:
  - Term of years provision
  - No guarantee by the managing partner(s) or managing member(s) regarding the return of any owners capital or any cash distributions
- Approval rights of limited partners or non-managing members required for certain major decisions
- Limited partners, non-managing members and assignees excluded from management
- How the election of new managing members is accomplished
- Distances limited partners, non-managing members and assignees from the assets of the FLP

MORE ON UNDERSTANDING THE AGREEMENT

- The right of the GP or managing member to determine whether cash will be distributed and at what amount
- Capital call provisions that obligate partners, members, or assignees
- Limitations on the voluntary and involuntary transferability of general partner, limited partner, member and assignee interests
- First refusal rights
- Whether the transferee of an interest is a partner, member or assignee
- Consent of all owners required for a transferee or assignee of an interest in th FLP/LLC to become a substituted limited partner or member
- General Partners or managing members eligible or required to make Sec 754 elections
- Limitations on the right of GPs to withdraw from the partnership prior to the expiration of its stated term

STILL MORE....

- Should the GP/MM exercise his power to withdraw early the GP/MM interest shall become a limited partner interest, and the partner may also be subject to damages breach
- Ability of LP, member or assignee to withdraw from the FLP prior to expiration of stated term
- Provisions for dissolution of the FLP mirroring state law

SOME ADDITIONAL FACTORS THAT NEED TO BE CONSIDERED

- Size of the interest
- Number of investors in the FLP/LLC
- Type of assets owned by the FLP
- Are assets well diversified
- Current & historical amount of cash distributed to partners, members and assignees
- Underlying cash flow coverage of yearly distributions
- The "default rules" under state law
- Mgmt Competency
- Financial leverage inherent in the FLP/LLC capital structure
- Caliber of the information from the FLP/LLC
- Universe of interested buyers

CAVEATS

- FLP assets should be expected to appreciate in value
- Personal assets (especially a personal residence) should not be placed in an FLP. FLP must have legitimate business purpose (Consider using a QRPRT instead)
- All personal assets not advisable to be placed in a FLP/LLC because the owners should maintain enough assets outside the FLP/LLC to pay personal bills & expenses without relying on FLP/LLC distributions to make good on those obligations

VALUATION CONSIDERATIONS

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- Each of the three basic valuation approaches should be considered
  - Asset Asset
  - Income Approach
  - Market Approach

- The approach that is relied on most heavily will depend on the characteristics of the subject interest

- Historically, many valuation analyst's use the Asset Approach to value a FLP/LLC

ASSET APPROACH

- Generally considered to be the value a controlling interest could liquidate the underlying assets & liabilities
- The NAV is the sum of the toal market value of the FLP assets minus its liabilities.
- Adjust book value of assets to FMV and reduce them by the liabilities
- Establishing FMV of cash or investment interests usually use bank and investment acct statements
- Publicly traded securities/investments can usually be determined as of a precise date by examining the exchange where the investment can be traded
- The value of less liquid investments may not be determined easily
  - Some investment funds may only provide valuations quarterly
  - FLPs that hold real estate or equipment may require appraisals by specialists in those areas

INCOME APPROACH

- Discount future cash flow (DCF) for each asset held by the FLP
- Appropriate rates of return can be derived using alternative rates of return from publicly traded stocks, bonds, real estate investments trusts (REITs) and limited partnership interests

MARKET APPROACH

- The market derived price/NAV multiples can be used to directly determine the non-controlling marketable falue of an FLP/LLC interest
- Requires careful analysis of entities that hold similar assets in their portfolio
  - Consider comparable entities that distribute similar amounts to their limited partners
  - Consider comparable leverage held by those comparable entities

VALUATION ADJUSTMENTS

VALUATION ADJUSTMENTS – DLOC

- Depending on the valuation methods used, these 2 adjustments may be in play::
  - Discount for Lack of Control (DLOC) &
  - Discount for Lack of Marketabililty (DLOM)
- In most cases, once the value of the FLP has been determined (especially when using the asset based approach), the valuation analyst will apply a DLOC to convert a controlling interest to a non-controlling interest
- Most common method to determine DLOC is to apply market derived P/NAV ratio
- Ratio captures the ROI that a minority owner would expect
- Data from closed-end mutual funds or publicly registered real estate partnerships can provide P/NAV ratios
- Qualitative & Quantitative comparisons should be made between the data to derive discounts for the subject interest

VALUATION ADJUSTMENTS – DLOM

- Use much the same analysis that an analyst would use for any other interest in a closely held entity
- An additional factor when considering a DLOM is to consider that there may be some lack of marketability data included in the market data used in the initial analysis. Be careful not to double count
- Publicly registered real estate limited partnerships are traded on a secondary market which is not nearly as liquid as the market for publicly traded stocks
- Analysts should consider the likelihood that the reported P/NAV ratios also include a msall discount for the time it would take to convert these assets to cash (i.e., marketability)

FAMILY LLCs

- Transfer appreciated assets into the LLC
- Translate market value of those assets into membership or LLC units (similar to stock value)
- Transfer ownership of minority interests to heirs
- Take advantage of discounting interests
  - The discount on the value of units transferred to non-managing members of an LLC is based on the fact that without mgmt. rights LLC units become less marketable

LOWERING YOUR ESTATE TAX BURDEN

WHAT HAPPENS AT YOUR DEATH?

POST MORTEM TAX PLANNING

- At death some states declare the LLC must dissolve unless a specific plan of succession is in place

- Dissolution can be avoided by providing for a transfer to another individual upon death as outlined in the operating agreement
  - Creating a joint tenancy membership,
  - Revocable trust to hold the LLC membership, or
  - Probating the LLC through court to determine the succession plan

DOWNSIDE RISKS

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- When compared to running your real estate business separately, the LLC is more expensive
  - California annual tax ($800) + annual franchise fee based on gross revenue (rents)
  - Various ongoing fees to maintain the LLC (legal & CPA fees)

ASSET PROTECTION BENEFITS

ASSET PROTECTION

- Owner(s) are not liable for he debts of the LLC
- LLC provides protection to the owner from creditors in the event the company defaults, enters bankruptcy or otherwise cannot make its obligations
- Including slip & fall liability from tenant injuries sustained on your property
- Review insurance policy protection limits to make sure you are adequately protectded
- Creditors are unable to attach owner's personal assets

CALL US TO SCHEDULE AN APPOINTMENT

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