

# The Consideration of Projected Income in the Valuation of Noncontrolling Ownership Interests

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*Most valuations of nonmarketable, noncontrolling ownership interests in family holding entities are prepared using only one valuation approach—the asset-based approach. The projected income associated with the subject noncontrolling ownership interest is often ignored in the valuation process. This discussion summarizes how projected income and required holding period can be incorporated in the valuation analysis through the use of an income approach valuation method. This discussion also illustrates how a properly applied income approach method can provide additional support for the asset-based approach value conclusion.*

## INTRODUCTION

The valuation of noncontrolling ownership interests is a common procedure in most transfer tax planning engagements. One of the many benefits of transferring noncontrolling and/or minority business interests is the ability to apply valuation discounts in the valuation of the subject business interest.

These valuation discounts may include (1) a discount for lack of ownership control, (2) a discount for lack of marketability, and/or (3) a discount for lack of voting rights.

The application of valuation discounts often results in a fair market value for the subject business interest that is significantly lower than the preliminary pre-discount value of the business interest.

Over the past several years, valuation discounts have been under constant scrutiny by the Internal Revenue Service. In many of these cases, the Service has claimed that the valuation discount(s) used by the taxpayer valuation analyst are either excessive or unsupported. This is particularly true in situations where the transferred ownership interest was in a generally passive business, such as: (1) certain family limited partnerships (FLP), (2) family limited liability companies (FLLC), or (3) other family holding company entities.

This scrutiny has caused many taxpayers (and their professional advisers) to take a much more careful and thoughtful approach to the valuation of noncontrolling business interests. In this regard, valuation analysts have started to use alternative valuation methods—namely income-based valuation methods—to supplement their analyses and provide additional analytical support for their value conclusion.

This discussion summarizes the general approach that analysts have used in the valuation of noncontrolling ownership interests of passive business entities. The discussion also addresses the advantages and disadvantages of using this generally accepted approach to valuation. The discussion also provides an illustrative example of how an income approach valuation method may be used to provide additional support to the typical approach of using a single valuation method in the valuation analysis.

## ACTIVE VS. PASSIVE BUSINESS ENTITIES

Whether the valuation of a business interest is prepared for tax-related purposes, transaction-related purposes, litigation-related purposes, or any other purpose, the valuation analysis may be conducted

using one of more of the three generally accepted valuation approaches—the market approach, the income approach, and the asset-based approach.

In the valuation of a noncontrolling ownership interest in an actively managed operating business, it is not uncommon for the valuation analyst to use more than one of the generally accepted approaches to conclude a value for the subject business interest.

For purposes of this discussion, the term “actively managed operating business” is used to describe a business entity (i.e., partnership, corporation, limited liability company, etc.) that generates a majority of its revenue and earnings from actively managed business activities such as manufacturing products, distributing products, providing services, and so on.

In contrast, in the valuation of a noncontrolling ownership interest in a passive business entity, it is common for the valuation analyst to use only one valuation approach—the asset-based approach—to conclude a value for the subject business interest.

For purposes of this discussion, the term “passive business” is used to describe a business entity that (1) operates as a holding company and (2) requires little, if any, day-to-day management.

Most often, the assets of passive business entities are easily valued and are either tangible or monetary in nature. And, many of these passive business entities have little or no intangible assets.

Some of the more common passive business entities that a valuation analyst may encounter are FLP, FLLC, or other family holding company entities that are funded with highly liquid assets that have a readily observable market value.<sup>1</sup>

The most common of these entities is the FLP or FLLC that owns a portfolio of highly liquid marketable securities (“marketable securities FLP”).

## GENERALLY ACCEPTED VALUATION APPROACH/METHOD TO VALUE INTERESTS IN PASSIVE BUSINESS ENTITIES

In situations where the analyst is valuing a noncontrolling ownership interest in a marketable securities FLP, the valuation analyst is faced with the decision of using either a market approach, an income approach, an asset-based approach, or any combination of these three generally accepted approaches. In many cases, the valuation analyst will choose not to use a market approach because of the lack of relevant guideline company data.

More specifically, the valuation analyst may choose not to use the guideline publicly traded company method of the market approach. This is

because there are not any publicly traded companies that are reasonably similar to the subject marketable securities FLP.

In the same respect, the valuation analyst may choose not to use the guideline merged and acquired company method of the market approach. This is because of the lack of transaction data of merged and acquired businesses that are reasonably similar to the subject marketable securities FLP.

In the case of a marketable securities FLP, the analyst’s decision to not use a market approach can be the subject of criticism. The parties that advocate the use of a market approach often state that the public markets include several entities that are in the primary business of owning highly liquid securities (e.g., open-end mutual funds, closed-end mutual funds, publicly traded investment companies).

As a result, the valuation analyst could/should use the capital market pricing data from these entities to value an ownership interest in the marketable securities FLP.

The parties that generally disagree with the use of a market approach state that the publicly traded entities that hold marketable securities have characteristics that are fundamentally different than the characteristics of a typical closely held marketable securities FLP. These fundamental differences are usually in the management and structure of the business entity.

For example, a publicly traded entity that owns marketable securities (e.g., a closed-end mutual fund) typically has a well-defined investment strategy. The investment strategy is disclosed in the fund prospectus and the fund management is generally unable to deviate from that strategy. In contrast, most marketable securities FLPs give a broad range of investment discretion to the general partner or the FLP investment adviser.

The entity’s management, in its sole discretion, is often able to invest and reinvest in different asset classes (e.g., cash, fixed income securities, equity securities, alternative investments) and change the course of the business without the approval of the limited partners.

Another difference between the publicly traded entities that hold marketable securities and a typical closely held marketable securities FLP is that unit holders of a publicly traded entity typically expect an income return (e.g., dividend and/or income distribution) on their investment. In contrast, limited partners of a closely held marketable securities FLP may not receive any current return in the form of annual partner distributions.

This observation is especially true in situations where the general partner has the right to retain

partnership income for purposes of funding reserves and reinvestment.

Probably the most significant fundamental difference between publicly traded entities that hold marketable securities and a typical closely held marketable securities FLP is the difference in the marketability of the entities' ownership interests. Consequently, even in situations where the analyst is able to identify entities that are similar enough to the subject marketable securities FLP to be used in the guideline publicly traded company method, the valuation analyst is still faced with the need to adjust the indicated value of the marketable securities FLP units for their lack of marketability.

Since the discount for lack of marketability tends to be one of the largest adjustments in the valuation analysis, the adjustment is usually subject to a great deal of scrutiny.

## The Asset-Based Approach

The asset-based approach is the most common approach used in the valuation of a noncontrolling ownership interest in a marketable securities FLP. The asset accumulation method of the asset-based approach involves adjusting all of the assets (and liabilities) of the subject entity from a historical cost basis (or accounting book value basis) to a fair market value basis.

As the name of the method suggests, the fair market values of the assets are then accumulated to arrive at the cumulative fair market value of the entity's total assets. Should the entity have any liabilities, the liabilities are also restated on a fair market value basis.

The underlying principle in the asset accumulation method is that by adjusting total assets to fair market value and then subtracting the fair market value of the entity's liabilities, the valuation analyst has indirectly calculated the fair market value of the entity equity on a marketable, controlling ownership interest basis.

The attraction of the asset accumulation method, specifically in the context of a marketable securities FLP, is two-fold.

First, the asset accumulation method has intuitive appeal. Even the relatively inexperienced valuation analyst can understand the concept that the fair market value of a business enterprise, in its entirety, is equal to the cumulative fair market value of the entity's net assets. Many valuation analysts also take comfort in the Service's "endorsement" of the use of an asset-based approach in the valuation of a holding company-type of entity.

The use of the asset-based approach is addressed in Revenue Ruling 59-60 ("RR 59-60") as summarized below:

The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.<sup>2</sup>

While RR 59-60 uses the term "adjusted net worth" rather than the more common terms of net asset value or adjusted net asset value, the message is still clear. That is, the starting point for the valuation of an ownership interest in an investment-related holding company is the fair market value of the entity's underlying assets.

Second, the asset accumulation method is relatively easy to use. In the case of a marketable securities FLP, the first procedure of the asset accumulation method is the value of the FLP underlying assets. The underlying assets (i.e., marketable securities) are valued at the average of (1) their low trading price and (2) their high trading price as of the valuation date.

If the analyst is valuing a noncontrolling ownership interest in a marketable securities FLP, the next procedure of the asset accumulation method is to quantify various valuation adjustments. These valuation adjustments may include, but may not be limited to:

1. a discount for lack of ownership control,
2. a discount for lack of marketability, or
3. a combined discount which incorporates both lack of ownership control and lack of marketability.

The discount for lack of ownership control is usually quantified using pricing of publicly traded—or thinly traded—securities. Some of the more common types of market data that are used to support a discount for lack of ownership control are as follows:

1. price to net asset value (NAV) data derived from shares of publicly traded closed-end mutual funds
2. acquisition price premium data derived from transactions involving publicly traded common stock
3. price to net asset value data derived from units of publicly registered limited partnerships

Regardless of the type of data that is available to support the discount for lack of ownership control, the valuation analyst is invariably faced with the issue of identifying the data that is most suitable for the subject analysis. In the case of a marketable securities FLP, price to net asset value discount data from publicly traded closed-end mutual funds are commonly used to support a discount for lack of ownership control.

However, the price to net asset value discount provided by these funds can vary widely depending on (1) the type of closed-end fund and (2) market conditions. For example, the price to net asset value discount can range, on average, from 1 percent or 2 percent on the low end of the range to 30 percent or 35 percent on the high end of the range.

The valuation analyst has discretion as to which closed-end funds to select for a given analysis. And, this discretion has an impact on the discount for lack of ownership control that is ultimately used in the analysis.

After quantifying a discount for lack of ownership control to use in the asset accumulation method, the valuation analyst is still faced with the additional procedure of quantifying a discount for lack of marketability for the subject noncontrolling ownership interest.

Valuation analysts often rely on two types of models to quantify the appropriate discount for lack of marketability:

1. empirical models and
2. theoretical models.

Generally, empirical models use analyses that are based on empirical capital market transaction observations—rather than on theoretical economic principles. Alternatively, theoretical models do not rely on actual capital market pricing evidence, but are based on fundamental microeconomic relationships.

Empirical models rely on actual capital market transactions to provide evidence for estimating a discount for lack of marketability. There are two categories of empirical capital market studies commonly used to quantify the discount for lack of marketability for noncontrolling ownership interests:

1. studies of price discounts on sales of restricted shares of publicly traded companies (the “restricted stock studies”)
2. studies of price discounts on private stock sale transactions prior to an initial public offering (the “pre-IPO studies”)

Taken as a whole, the restricted stock studies support a discount for lack of marketability of approximately 20 percent to 35 percent. The pre-IPO studies support a discount for lack of marketability of approximately 45 percent to 50 percent.

Based on the unique characteristics of the noncontrolling ownership interest subject to valuation, there are times when one type of study is more relevant than another type of study. This is because marketability and lack of marketability are relative (and not absolute) terms.

In general, a thorough understanding of how the subject noncontrolling ownership interest compares to the interests analyzed in the various empirical discount for lack of marketability studies is important to the valuation adjustments analysis. For example, if the subject ownership interest in the marketability securities FLP has an expected holding period of two years or less, then it may be more meaningful to place more emphasis on the results from the restricted stock studies than the results from the pre-IPO studies.

Alternatively, if a public market or liquidity event is not expected to occur for many years, then the results from the pre-IPO studies may be more meaningful.

The selected discount for lack of marketability will ultimately be based on entity-specific and security-specific factors such as:

1. dividend payments (or lack thereof)
2. expected holding period for the ownership interest
3. subject entity risk

The importance of analyzing the subject entity relative to the empirical discount for lack of marketability studies is illustrated by the wide range of discounts observed within the empirical study. The wide range of observed discounts illustrates that a multitude of entity-specific and security-specific factors affect stock pricing and the size of the discount for lack of marketability.

In summary, the valuation analyst may use the asset accumulation method to arrive at the net asset value of a marketable securities FLP. This procedure is usually completed with relative ease.

The difficulty of using the asset accumulation method in the valuation of a noncontrolling ownership interest is usually in the selection (and the support) of the various valuation adjustments, specifically, the discount for lack of ownership control and the discount for lack of marketability.

As previously discussed, the empirical pricing data that are used to support both (1) a discount for lack of ownership control and (2) a discount for lack of marketability vary widely. Furthermore, the analyst has a great deal of discretion on how to apply that data in the valuation.

Often, this discretion results in situations where the valuations prepared on the behalf of the taxpayers are viewed by the Service as being too aggressive. In other words, the Service contends that the selected valuation discounts within the asset accumulation method are excessive and lack sufficient support.

In these situations, settlement discussions with the Service usually revolve around the extent of the valuation discounts. This is because the net asset value of the entity is rarely in dispute. This observation is especially true in the context of a marketable securities FLP.

In an effort to further support the valuation adjustments that are applied in the asset accumulation method, many valuation analysts have supplemented their analyses with income-based valuation methods.

In using an income-based valuation method, the valuation analyst is able to value an ownership interest by using the projected returns that are specific to the subject ownership interest.

## INCOME-BASED VALUATION METHODS

While RR 59-60 clearly states that adjusted net asset value should be accorded greater weight in the valuation of a closely held investment holding company than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity, it does not address the issue of quantifying the valuation adjustments used within the asset-based approach.

Furthermore, RR 59-60 does not preclude the valuation analyst from using an income-based valuation method to provide analytical support for the valuation adjustments included in the asset-based approach.

Valuation theory states that the value of an asset is equal to the present value of the asset's expected returns. Based on this principle, an analyst may value a noncontrolling ownership interest in a marketable securities FLP by estimating the present value of the expected total returns related to the ownership interest.

These returns normally come in the form of annual income distributions. However, the returns may also reflect capital distributions from the sale or distribution of partnership assets.

A case can be made that the further removed a particular ownership interest is from managing (or controlling) the FLP (e.g., a limited partnership interest) the more important income distributions are to the noncontrolling interest holder.

In other words, if a limited partner is unable to dictate the timing of asset sales, the distribution of asset sale proceeds, and the termination and liquidation of the FLP, the limited partner will depend exclusively on income distributions as a means of a return.

One common income approach valuation method that may be used to value noncontrolling ownership interests in marketable securities FLPs is the discounted cash flow method, or the discounted distribution method (DDM).

There are four procedures in the DDM. The first procedure is to develop financial projections for the subject FLP. This procedure considers the marketable securities FLP's current investment portfolio and how that portfolio may change over time. Based on the current and the projected composition of the FLP investment portfolio, the analyst is able to project the income and the capital appreciation for each segment of the investment portfolio.

The second procedure of the DDM is to develop a distribution payout schedule for the FLP. This stage of the analysis requires a thorough review of the FLP partnership agreement to understand if, when, and how partner distributions will be paid by the subject FLP. Consultation with FLP management is common at this phase of the analysis.

The third procedure of the DDM is to estimate the terminal value of the FLP. As will be discussed in the following illustrative example, the holding period for a limited partnership interest in a marketable securities FLP may vary greatly from one partnership to another.

To allow for the uncertainty regarding the expected holding period of the investment, the valuation analyst may incorporate several different expected holding periods in the DDM. For each expected holding period, the analyst projects a discrete terminal value for the FLP investment portfolio.

The fourth procedure is the selection of an appropriate present value discount rate to use in estimating the present value of the future returns (i.e., income distributions and the terminal value). It is noteworthy that the present value discount rate should reflect all of the risks of owning a nonmarketable, noncontrolling ownership interest in the subject marketable securities FLP.

Generally, it is not sufficient to use the estimated annual return on the FLP investment portfolio as the present value discount rate. While this expected return may be appropriate for a direct investment in the FLP investment portfolio, the return does not properly reflect the risk for lack of ownership control and lack of marketability that are inherent in a limited partnership interest.

As a result, it is not uncommon for the analyst to use a present value discount rate in the DDM that is significantly higher than the estimated annual return of the FLP investment portfolio.

In supporting an estimated annual return for a nonmarketable, noncontrolling limited partnership interest, the analyst may consider various rates of return market data. These data may include:

1. rates of return on thinly traded partnership interests (e.g., publicly registered limited partnership interests),
2. expected rates of return on illiquid private equity investments, and
3. historical and expected rates of return on micro-cap common equities.

The present value of (1) the FLP projected income distributions and (2) the FLP projected terminal value equates to the present value of the FLP partners' equity on a nonmarketable, noncontrolling ownership interest basis.

Since the concluded value is on a nonmarketable, noncontrolling ownership interest basis, there is no need for the analyst to apply valuation adjustments to the value conclusion for (1) lack of ownership control and (2) lack of marketability.

The concluded fair market value of the FLP partners' equity that was estimated using the DDM may be compared to the undiscounted net asset value of the FLP. These two values are used to compute the total implied discount that is implied by the DDM conclusion.

This combined valuation discount is then used as a reasonableness check for the combined discount that was used in the asset accumulation method.

In this respect, the selected valuation discounts that were used in the asset accumulation method will not be based solely on the previously discussed

empirical data and studies. Instead, the selected discounts will also be supported by the DDM analysis.

The following discussion presents an illustrative example of how the income approach could be used to value a noncontrolling ownership interest in a marketable securities FLP.

## ILLUSTRATIVE EXAMPLE

This illustrative example involves a valuation of a 20 percent nonmarketable, noncontrolling ownership interest in Balanced Fund Investments, L.P. (BFI). BFI is a marketable securities FLP. As of the valuation date, January 1, 2010, BFI had total assets of \$10 million and no liabilities.

The market value of the BFI total assets was as follows: (1) cash and cash equivalents of \$500,000; (2) publicly traded corporate bonds of \$3.5 million; (3) publicly traded U.S. equity securities of \$5.0 million; and (4) alternative investments of \$1.0 million.

As presented in Exhibit 1, the BFI total assets were expected to generate \$260,000 of annual income. The cash and cash equivalents had a current yield of 2.0 percent. The corporate bonds had a current yield of 5.0 percent.

The U.S. equity securities had a current yield of 1.5 percent. The alternative investments were not expected to generate annual income.

For purposes of this illustrative example, let's assume that the BFI partnership agreement requires that the general partner distribute the BFI net income on at least an annual basis. Let's further assume that the general partner has unilateral control of the BFI operations.

In other words, the general partner is able to actively buy and sell partnership assets and change the composition of the BFI investment portfolio.

Our illustrative example also assumes that the BFI partnership units are nonmarketable. In this regard, we need to assume the following:

- There have not been any transactions in the BFI partnership units.
- BFI has not provided liquidity to the BFI partners by offering to redeem their partnership units.
- The BFI partnership agreement contains restrictive language that prevents the BFI partners from freely transferring their partnership units.
- The BFI partners are unable to withdraw from BFI prior to its termination.
- There is no expected liquidity event for the BFI partnership units (e.g., a sale of BFI or an offering of its partnership units).

Finally, let's assume that BFI has a remaining term of eight years, but there is uncertainty as to whether the partners will elect to extend the partnership term beyond eight years.

As presented in Exhibit 1, the BFI net asset value of \$10 million translates to a net asset value of \$2 million for a 20 percent limited partnership interest.

As previously described, the asset accumulation method necessitates the application of (1) a discount for lack of ownership control and (2) a discount for lack of marketability in the valuation of a 20 percent limited partnership interest.

Let's assume that based on our review and analysis of (1) market pricing data and (2) the results of various empirical studies, we concluded that a discount for lack of ownership control of 12 percent and a discount for lack of marketability of 30 percent is appropriate for a 20 percent limited partnership interest in BFI.

Applying the selected valuation adjustments in sequence results in a fair market value for the 20 percent limited partnership interest of \$1.232 million.

In other words, the asset accumulation method resulted in a total concluded discount from net asset value for the 20 percent limited partnership interest of approximately 38 percent.<sup>3</sup>

The valuation analyst may use the asset accumulation method as the sole method of estimating the fair market value of the subject limited partnership interest. However, in doing so, the accuracy of his analysis would hinge entirely on the appropriateness of the selected valuation adjustments.

In other words, if an adversary was successful in proving that the selected valuation adjustments were inappropriate, the entire analysis would be unreliable.

At this stage of the analysis, the analyst should question whether a second valuation method—specifically an income approach method—could or should be used to provide additional support for the concluded net asset value discount of 38 percent.

## Exhibit 1 Balanced Fund Investments, LP Asset-Based Approach—Asset Accumulation Method As of January 1, 2010

Security Description	Fair Market Value \$	% of Total Portfolio %	Estimated Annual Income \$	Current Yield %
Cash and Cash Equivalents	500,000	5.0	10,000	2.0
Corporate Bonds	3,500,000	35.0	175,000	5.0
U.S. Equities	5,000,000	50.0	75,000	1.5
Alternative Investments	<u>1,000,000</u>	<u>10.0</u>	<u>--</u>	<u>0.0</u>
Net Asset Value of Balanced Fund Investments, LP	10,000,000	<u>100.0</u>	<u>260,000</u>	<u>2.6</u>
New Asset Value of a 20% LP Interest	2,000,000			
Less: Discount for Lack of Ownership Control @ 12 %	<u>(240,000)</u>			
Marketable, Noncontrolling Value of a 20% LP Interest	1,760,000			
Less: Discount for Lack of Marketability @30%	<u>(528,000)</u>			
Fair Market Value of a 20% LP Interest	<u>1,232,000</u>			
Concluded Discount from Net Asset Value		<u>38%</u>		

Exhibit 2 provides a DDM for BFI. For purposes of the DDM, let's assume that the analyst was able to determine the following conclusions based on his (1) review of BFI documents, (2) review of capital market rates of return, and (3) discussions with BFI management:

- BFI intends to hold \$500,000 of cash and cash equivalents throughout the remaining term of the partnership. Furthermore, cash and cash equivalents are projected to earn an annual income yield of 2 percent.
- The BFI \$3.5 million investment in corporate bonds is expected to generate an annual yield of 5 percent, or \$175,000. BFI intends to hold \$3.5 million of corporate bonds throughout the remaining term of the partnership. Also, we assume that BFI will purchase new bonds with a current yield of 5 percent to replace the bonds that periodically mature during the term of the partnership.
- The U.S. equity securities are projected to generate two returns—an annual income return and capital appreciation. The estimated annual income on the equities is projected to be 1.5 percent of the market value of the equities. In addition to this dividend return, the equity securities are projected to appreciate at a rate of 8 percent per year.
- The alternative investments are projected to appreciate at a rate of 11 percent per year. However, the alternative investments are not projected to generate annual income.

## Exhibit 2 Balance Fund Investments, LP Income Approach—Discounted Distribution Method As of January 1, 2010

Fiscal Year Ended December 31,	A		B		C		A+B+C			Present Value Factor 16%	Present Value of Net Income \$	Implied Discount From NAV %	
	Estimated Income from Cash and Cash Equivalents 2.0%	\$	Estimated Income from Corporate Bonds 5.0%	\$	Estimated Value of U.S. Equities 8.0%	Estimated Income from U.S. Equities 1.5%	\$	Estimated Value of Alternative Investments 11.0%	\$				LP Operating Expenses
Portfolio Structure at 1/1/10	500,000		3,500,000		5,000,000		1,000,000						
2010	10,000		175,000		5,400,000		78,000		1,110,000	10,000		253,000	234,911
2011	10,000		175,000		5,832,000		84,240		1,232,100	10,300		258,940	207,256
2012	10,000		175,000		6,298,560		90,979		1,367,631	10,609		265,370	183,105
2013	10,000		175,000		6,802,445		98,258		1,518,070	10,927		272,330	161,982
2014	10,000		175,000		7,346,640		106,118		1,685,058	11,255		279,863	143,514
2015	10,000		175,000		7,934,372		114,608		1,870,415	11,593		288,015	127,331
2016	10,000		175,000		8,569,121		123,776		2,076,160	11,941		296,836	113,124
2017	10,000		175,000		9,254,651		133,678		2,304,538	12,299		306,380	100,646
2018	10,000		175,000		9,995,023		144,373		2,558,037	12,668		316,705	89,691
2019	10,000		175,000		10,794,625		155,922		2,839,421	13,048		327,875	80,034
2020	10,000		175,000		11,658,195		168,396		3,151,757	13,439		339,957	71,561
2021	10,000		175,000		12,590,851		181,868		3,498,451	13,842		353,026	64,039
2022	10,000		175,000		13,598,119		196,417		3,883,280	14,258		367,160	57,424
2023	10,000		175,000		14,685,968		212,131		4,310,441	14,685		382,445	51,554
2024	10,000		175,000		15,860,846		229,101		4,784,589	15,126		398,975	46,361
Terminal Value	500,000		3,500,000		15,860,846				4,784,589				2,863,800
Estimated Value of the LP Interests on a Nonmarketable, Noncontrolling Ownership Interest Basis (15-Year Holding Period)													4,596,331
Estimated Value of the LP Interests on a Nonmarketable, Noncontrolling Ownership Interest Basis (10-Year Holding Period)													5,746,064
Estimated Value of the LP Interests on a Nonmarketable, Noncontrolling Ownership Interest Basis (8-Year Holding Period)													6,383,062
Estimated Value of the LP Interests on a Nonmarketable, Noncontrolling Ownership Interest Basis (5-Year Holding Period)													7,613,422



As presented in Exhibit 2, the BFI investment portfolio is projected to generate \$263,000 of income in 2010. This income is comprised of (1) interest income on the cash and cash equivalents, (2) interest income on the corporate bonds, and (3) dividend income on the U.S. equity securities.

Furthermore, the annual income is projected to increase in subsequent years as the market value of the BFI investment portfolio increases.

The DDM also considers that BFI will incur annual operating expenses. These expenses, which are estimated to be \$10,000 in 2010, may include legal expenses, accounting/tax preparation expenses, and other miscellaneous operating expenses.

The DDM projects that the BFI operating expenses will increase at an inflationary rate of 3 percent per year.

Subtracting projected operating expenses from projected income results in projected net economic income. As presented in Exhibit 2, the BFI net economic income is projected to be \$253,000 in 2010, or approximately 2.5 percent of the BFI net asset value of \$10 million.

While the BFI net income is projected to increase each year as the investment portfolio appreciates, it is noteworthy that a holder of the subject 20 percent limited partnership interest would only expect its pro rata portion of the BFI net income each year.

This level of net income represents a relatively nominal annual return on the net asset value of the 20 percent limited partnership interest. Consequently, the longer it takes a holder of the subject 20 percent limited partnership interest to realize a return of capital on his investment (e.g., sale or liquidation of the limited partnership interest), the higher the implied valuation discount from net asset value.

In other words, this holding period risk is appropriately captured in the DDM.

The DDM presented in Exhibit 2 includes a present value of future returns for four different holding periods. For each holding period, the present value of the projected partnership net income is added to the present value of the projected partnership terminal value at the end of the respective holding period.

For example, the present value of the partnership returns for a 15-year holding period includes:

1. the present value of the projected BFI net income for the period of 2010 through 2024 and
2. the present value of the projected market value of the BFI investment portfolio at the end of 2024.

Likewise, the present value of the partnership returns for a 5-year holding period includes:

1. the present value of the projected BFI net income for the period of 2010 through 2014 and
2. the present value of the projected market value of the BFI investment portfolio at the end of 2014.

As previously mentioned, the selected present value discount rate for the DDM should reflect the expected return on the subject limited partnership interest after considering (1) the BFI business, risk, and investment portfolio and (2) the lack of control and lack of marketability inherent in the subject limited partnership interest.

As a point of reference for the minimum expected return on the subject ownership interest, the analyst may compute the weighted average return of the BFI investment portfolio. As presented in Exhibit 3, the BFI investment portfolio had a weighted average portfolio return of approximately 8 percent.

As a result, an investor would expect an 8 percent rate of return if it had a direct ownership interest in the BFI investment portfolio.

For purposes of the DDM, let's assume that an investor would demand a return of 15 percent to 18 percent to be compensated for the risks inherent in the 20 percent limited partnership interest.

Using these market data, the valuation analyst can discount the future returns to a present value using the required rate of return on the subject ownership interest. The DDM presented in Exhibit 2 incorporates a present value discount rate of 16 percent. Using this present valuation discount rate, the analyst arrives at a present value for the BFI partners' equity for each of the required holding periods.

The concluded present value of each required holding period may be compared to the BFI net asset value to compute the implied valuation discount that is implied by the DDM.

As expected, a longer expected holding period for a limited partnership interest translates to a higher valuation discount from net asset value, all else being equal.

Exhibit 4 presents the indicated present value (i.e., fair market value) of the BFI partners' equity and the implied valuation discount from the January 1, 2010 net asset value for the four different holding period scenarios.

Given (1) the remaining expected term of BFI and (2) the expected holding period of other illiquid investments (e.g., private equity fund interests, etc.), let's assume that the valuation analyst estimated a required holding period—or period of

### Exhibit 3 Balanced Fund Investments, LP Weighted Average Portfolio Return As of January 1, 2010

Security Description	Total Expected Return %	% of Total Portfolio %	Weighted Average Return %
Cash and Cash Equivalents	2.0%	5%	0.1%
Corporate Bonds	5.0%	35%	1.8%
U.S. Equities	9.5%	50%	4.8%
Alternative Investments	11.0%	10%	<u>1.1%</u>
Weighted Average Portfolio Return (rounded)			<u>8%</u>

illiquidity—of eight to ten years for the 20 percent limited partnership interest.

Given this period of illiquidity, the DDM supports a discount from net asset value of approximately 36 percent to 43 percent. Consequently, the DDM provides analytical support that the valuation discount of 38 percent used in the asset accumulation method is reasonable.

In summary, the illustrative example demonstrated how the projected income of a marketable securities FLP can be used:

1. as a basis for estimating the fair market value of a noncontrolling ownership interest in the FLP and
2. to support the valuation discount that is incorporated in the asset accumulation method.

## SUMMARY AND CONCLUSION

In the valuation of noncontrolling ownership interests in passive business entities, valuation analysts

have traditionally relied on a single valuation approach to reach a value conclusion.

With the additional scrutiny that the Service has placed on the valuation of noncontrolling ownership interests—specifically ownership interests in passive business entities—valuation analysts have been compelled to develop additional analyses to support their value opinions.

While an asset-based approach has been the most common approach for valuing noncontrolling ownership interests in many passive business entities, the income approach has proved to be of practical use.

This observation is especially true in situations where the holder of the subject noncontrolling ownership interest (1) does not have any influence over the management of the business enterprise and (2) can reasonable expect only an annual income return on its investment—rather than an income return and a return of capital.

A properly applied income approach method, such as the DDM, can provide analytical support for the valuation discounts used in the asset-based approach.

The income approach method will also reinforce the principle that (1) projected income (i.e., distributions) and (2) required holding period—or expected period of illiquidity—are two important factors that have a direct impact on the value of a noncontrolling ownership interest.

### Notes:

1. This discussion does not imply that all FLP, FLLC, or other family holding entities are passive business entities. Many of these family holding entities transact business on a daily basis, and/or require a significant amount of active, daily professional management and strategic oversight.
2. Rev. Rul. 59-60, 1959-1 C.B. 237, Sec. 5(b).
3. The concluded discount of approximately 38 percent is computed as  $[1 - (\$1,232,000 \div \$2,000,000)] \times 100$ .

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### Exhibit 4 Balanced Fund Investments, LP Income Approach Indications of Value Based on Based on Expected Holding Periods As of January 1, 2010

Expected Holding Period	Indicated Fair Market Value	Implied Discount from NAV
15 Years	\$4,596,331	54%
10 Years	\$5,746,064	43%
8 Years	\$6,383,062	36%
5 Years	\$7,613,422	24%