

# Valuations Plus

## Valuation issues for cash-rich FLPs: An analysis

**T**here has been a great deal of interest in estate planning now that 2010 is almost over, and Congress is not expected to fix the gift and estate tax issues any time soon.

As a result, a lot of valuations are coming along dealing with family limited partnerships (FLPs), the apparent investment entity of choice for gift and estate planning.

One area that doesn't always receive as much attention as other mainstream valuation issues is that of liquidity inside the FLP.

What follows is a summary of current research on the topic and some notions on applicability of the question: "How much cash is reasonable – and 'discountable' – inside a family limited partnership?"

In the valuation analysis of FLPs, whether they are invested in portfolios of marketable securities, real estate, or other interesting investments sometimes found in FLPs, the core market data that is typically analyzed for comparative pricing purposes consists of closed-end funds and publicly traded limited partnerships.

Closed-end funds (CEFs) are like open-end mutual funds, which allow investors the opportunity to buy into portfolios run by professional managers. However, closed-end funds have no obligation to redeem their own investors' shares upon demand but

behave instead like ordinary publicly traded companies. In that regard, publicly traded real estate limited partnerships (RELPs) behave like closed-end funds. This allows their professional managers to focus on maximizing port-

folio returns without the concern of carrying cash, or unexpectedly liquidating positions, to redeem upon demand.

Investors are free to buy and sell their shares through stock

brokers, and in effect, "vote with their feet" if they disapprove of management or simply wish to reallocate their own portfolios to other investments.

Perhaps not surprisingly, the market data shows that CEFs hold very little in the way of cash. This is consistently true for almost all of the several hundred CEFs researched, covering all of the major asset classes and investment styles for stocks and bonds. The typical range for cash positions was less than five percent.

Only a few closed-end funds have held a larger portion of their portfolio in cash at any point in the past couple of years (some, seemingly in response to stock market conditions, reduced their equity exposure for one or two quarters and then reinvested).

The only closed-end funds that seem to consistently maintain a higher cash position than a few percent are those that have an investment policy that allows them to invest a substantial portion of their portfolio in nontraded securities (such as private companies, venture capital investments, etc.).

We considered whether newly formed closed-end funds might behave differently from long-running CEFs. However, an analysis of newly formed closed-end funds, those created just within the past 18 months, shows virtually no difference – their cash position is just as small as that of established CEFs.

Publicly traded real-estate limited partnerships, based on records found on SEC.gov and other valuation databases

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# Tax Court burns couple's charitable deduction claims

**C**an you have your house burned down in a training exercise by the fire department and take a charitable deduction?

Apparently not, at least in one case.

The decision of the United States Tax Court in *Theodore R. Rolfs, et. ux. v. Commissioner* (135 T.C. No. 24, Nov. 4, 2010) is the latest case involving taxpayers claiming a charitable contribution deduction for allowing a local fire department to burn down an existing structure so that the taxpayers could construct a new one.

\$15,000 to tear down the lake house and remove the debris. Rolfs then contacted the local volunteer fire department and arranged for the lake house to be burned to the ground in a training exercise.

Based on an appraisal, Rolfs and Gallagher claimed a \$76,000 charitable contribution deduction for transferring the lake house to the volunteer fire department.

To arrive at this value, the appraiser used a before-and-after approach. On the basis of comparisons to direct sales of comparable properties, the appraiser

should be reduced by the value of any benefit Rolfs and Gallagher received by having the lake house demolished. The court essentially agreed with the IRS.

The court determined that Rolfs and Gallagher received a benefit of \$10,000 or more by avoiding the cost of demolishing the lake house. In addition, the court rejected the appraiser's before-and-after approach to valuing the lake house.

In the view of the court, by transferring the lake house but not the underlying land to the fire department, Rolfs and Gallagher created a substantial restriction or condition on the property's marketability – namely, a potential buyer would have to be ready to relocate the lake house.

The court was persuaded by two experts in the field of house moving who testified on behalf of the government. Both experts concluded that the likelihood of a buyer purchasing the lake house to move it from the site was virtually nil because the characteristics of the lake house and its site rendered a relocation of the structure infeasible.

Additionally, the couple attached two other restrictions or conditions on the lake house incident to its donation – namely, the permissible use of the lake house was restricted to firefighter and police training exercises, and there was a condition that the lake house be burned down relatively soon after conveyance. Therefore, the lake house could no longer be used for residential purposes.

The court concluded that it was most proper to value the lake house as a “structure to be moved.” Since the cost and feasibility of moving the lake house was prohibitive, the court then looked to salvage value. Here, one of the government's experts testified to the effect that the value of any salvageable materials would be offset by the cost of removing them. So the lake house had zero salvage value.

The court concluded that the lake house, detached from the land and restricted as to use, was worthless at the time it was transferred to the fire department. Therefore, it allowed no charitable contribution deduction. – *Michael Redemske, CPA*



**T**he court concluded that the lake house, detached from the land and restricted as to use, was worthless at the time it was transferred to the fire department.

Theodore Rolfs and Julia Gallagher paid \$600,000 for three acres of lakefront property. The property was accessible only by a private road owned by an association.

At the time of the purchase, the property included a lake house, a detached garage, a boathouse, a well and a septic system. The lake house was a 3,000-square-foot structure approximately 100 years old. The house was habitable and in good condition. The local assessor assessed the property at \$460,100, allocating \$323,000 to the land and \$137,100 to the improvements.

After deciding to build a new home on the property, Rolfs and Gallagher determined that it would cost \$10,000 to

determined that the value of the property with all improvements was \$675,000. By reviewing direct sales of comparable vacant land, the appraiser estimated the land value at \$550,000.

By subtraction, the appraiser valued the improvements at \$125,000. Using replacement cost less physical depreciation, the appraiser estimated the value of the other structures (other than the lake house) on the property at \$29,000 and certain site improvements at \$20,000. That left \$76,000 for what the appraiser called the “contributory value” of the lake house.

The IRS argued that the amount of any charitable contribution deduction

# Financial ratios

## Vital tools that measure your company's progress

If you were asked today how your business is doing, how would you answer the question?

Clearly, your answer will be based upon your own personal frame of reference. But, since everyone does not share your frame of reference, financial ratios are frequently used to standardize the response.

Ratio analysis gives you the tools to identify and quantify many of your company's strengths and weaknesses. Comparing your ratios year-by-year provides you with important trend information pinpointing areas of concern. Comparing your ratios with other companies in your industry provides you with valuable information about your business operations compared to your peers.

There are five common categories of ratios that you or others may use to analyze your company's operations – growth, cost control, turnover, profitability and risk. Each of these categories contains many types of ratios. Some of the more important of these are described below.

### GROWTH RATIOS

**Sales Growth Percentage.** This ratio produces a percentage increase (or decrease) in your net sales from one period to the next. It is the simplest and most popular ratio used to measure your company's success or failure in generating sales.

$$\frac{\text{Year 2 Net Sales} - \text{Year 1 Net Sales}}{\text{Year 1 Net Sales}}$$

**Earnings Growth Percentage.** This ratio measures the percentage increase or decrease in your net earnings from one period to the next. It is a powerful ratio, which indicates whether you are experiencing positive or negative growth in your earnings.

$$\frac{\text{Year 2 Earnings} - \text{Year 1 Earnings}}{\text{Year 1 Earnings}}$$

### COST CONTROL RATIOS

**Gross Margin Percentage.** This ratio is critical if your company buys resources such as inventory and labor and uses them to produce a product, which is sold to your customers. The ratio measures the percentage of your sales dollar left after covering costs to produce the product sold. It helps to determine whether you are charging enough for your product to generate income to cover general and administrative expenses.

$$\frac{\text{Net Sales} - \text{Cost of Sales}}{\text{Net Sales}}$$

**Operating Expense(s) Percentage.** This ratio can be used to compare any or all of your operating expenses in a given period to net sales. It is commonly used to measure your ability to control operating expenses in relation to your company's fluctuating net sales.

$$\frac{\text{Operating Expense(s)}}{\text{Net Sales}}$$

**Net Operating Profit Percentage.** This ratio measures the percentage of your sales that remain as profit after covering all of your operating expenses. It is one of the most important ratios available to measure your ability to turn a profit on your sales.

$$\frac{\text{Net Operating Profit}}{\text{Net Sales}}$$

### TURNOVER RATIOS

**Inventory Turnover.** This ratio determines the number of times that you sell, or turn over, your average inventory. High inventory turnover can be a sign of your superior merchandising capabilities. Low inventory turnover probably indicates that your company's inventory levels are too high in relation to your sales. If your company buys and sells inventory for its livelihood, this ratio is critically important.

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

**Accounts Receivable Turnover.** This ratio produces a rough indication of the average time required to convert your company's accounts receivable into cash. It can be expressed in number of days by taking the result and dividing it into 365. A low accounts receivable turnover can be a sign of ineffective collection policies and liquidity problems.

$$\frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

**Fixed or Total Assets Turnover.** This calculation indicates your ability to effectively use your company's assets. The ratio is usually expressed as either a fixed assets turnover or total assets turnover. The results indicate the number of sales dollars you are generating with a dollar of assets. When viewed over time, these ratios indicate changing levels of asset productivity.

$$\frac{\text{Net Sales}}{\text{Average Fixed or Average Total Assets}}$$

### PROFITABILITY RATIOS

**Return on Assets or Equity.** These ratios are an important measure of your ability to earn a return on the funds supplied to your business. The return on total assets ratio measures your company's earnings in relation to all funds made available to it. If your company is large with a substantial stockholder investment, the return on equity ratio provides a useful measure of your stockholders' return on their investment.

$$\frac{\text{Net Income}}{\text{Average Total Assets or Average Total Equity}}$$

### RISK RATIOS

**Current Ratio Factor.** This ratio gives an indication of your company's ability to meet its short-term obligations. Generally, the higher the current ratio, the better your liquidity and ability to pay your current debts with current assets.

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

**Total Debt/Total Equity Percentage.** This ratio expresses the percentage relationship between the capital contributed to your company by creditors and that contributed by your owners. The higher the ratio, the greater the risk assumed by your creditors. A high ratio may signal an excessive interest expense level and less flexibility to borrow needed funds in the future.

$$\frac{\text{Total Debt}}{\text{Total Equity}}$$

Ratios provide vital information to help analyze your company's direction, profitability, use of resources, liquidity and management skills. In addition to providing you with important information, ratio analysis also provides outside interested parties with a way to analyze your company objectively. ■

## FLPs – an analysis *continued from front*

show more diversity. In looking at a published database of the more than 100 RELPs that are still operating, a majority show cash ranges between 5 percent and 10 percent of assets.

More interestingly, many show substantially larger cash positions, upward of 30 percent to 40 percent of their balance sheet invested in cash, at different points and for substantial

**P** rivate FLPs have different reasons and investment rationales for holding cash and retained earnings than their publicly traded parallels.

periods in their recent history. While in some instances, the jump in cash is due to a recent sale of a property or a refinancing, there is no consistent pattern. In at least a few of the examples, the cash

position has resulted purely from the retention of earnings over several years.

So what does this mean as far as family limited partnerships are concerned? What difference does it make to you? Well, it depends, of course.

Much like private companies that have different motivations and reasons than public companies for holding cash and retaining earnings, private FLPs have different reasons

and investment rationales for holding cash and retained earnings than their publicly traded parallels, CEFs and RELPs.

That said, what we have found – or rather haven't found yet – is that the market data typically used in analyzing FLPs for valuation purposes strongly support large proportions of cash.

While this does not preclude such a situation from existing in an FLP, it does highlight the need to emphasize those differences when documenting rationale in the valuation process. Such situations, which are not unusual in FLP settings, require a more thoughtful analysis of how all the assets in the FLP, including the cash, work together to accomplish the bona fide business goals set out for the FLP.

Simply applying a median pricing multiple (sometimes still referred to as the “implied lack of control discount”) derived from CEFs or RELPs, without a corresponding analysis, opens the door to a challenge of the quality and conclusions of the valuation exercise.

That reason alone is worth understanding how your valuation adviser is handling the analysis of your FLP, particularly if it is one holding substantial amounts of cash at the time the analysis is made. – *Victor Jarosiewicz, ASA, CFA*

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### *Valuations Plus*

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The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS. © 2011 CPAmerica International

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