MAXIMIZING VALUE THROUGH KNOWLEDGE

Fortifying and Defending Your $5.12 Million Gifts Against Attack – An Appraiser's Perspective

ADAMS CAPITAL INC.
BUSINESS VALUATION SERVICES

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TABLE OF CONTENTS

SECTION **PAGE**

1. START AT THE BEGINNING 5

2. VALUATION ABSOLUTES 5

3. MUCKING UP THE VALUATION ABSOLUTES 5

4. EMBRACE UNIQUENESS 6

5. WHY DOES IT MATTER? 7

6. WHAT SHOULD AN APPRAISAL CONSIDER? 8

7. TERM 9

8. MANAGEMENT 10

9. PROFITS AND LOSSES 16

10. TRANSFER 19

11. DISSOLUTION AND TERMINATION 27

12. SPECIAL RULES 33

13. DISPROPORTIONATE DISTRIBUTIONS 35

14. WRAPPING IT UP – REASONABLE RANGE SENSITIVITY 36

15. WE DO HAVE STANDARDS – THE USPAP CHECKLIST 37

16. CHARACTERISTICS OF A WELL-SUPPORTED VALUATION 40

17. BUILT-IN GAINS LIABILITY 41

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18. FILLING IN THE BLANKS – DISCRETIONARY FACTORS NOT EXPLICIT IN PARTNERSHIP AGREEMENTS 41

19. DISCOUNTS – WAIT JUST A MINUTE I DID NOT WANT IT THAT HIGH..... 42

20. MINIMUM LISTING REQUIREMENTS FOR A U.S. PUBLIC COMPANY 42

21. IN CASE OF IRS AUDIT – CONTACT YOUR APPRAISER..... 43

22. RESOURCES 43

23. CALL ME, MAYBE 43

24. PAY THE TAX 43

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About the Author

David Adams, CPA, ABV, ASA is president of Adams Capital, Inc. He is an expert in the valuation of businesses, business interests, and tangible and intangible property for mergers and acquisitions, corporate recapitalization, privatization, gift and estate tax planning, bankruptcy proceedings, dissenting shareholders, Employee Stock Ownership Plans, and financial and tax reporting. Prior to forming Adams Capital, Inc., Mr. Adams practiced business valuation services with Coopers & Lybrand LLP and KPMG Peat Marwick LLP, two of the international "Big Four" accounting and consulting firms.

Mr. Adams' extensive corporate finance background includes sellside and buyside advisory, divestitures, private placements, transaction negotiation, structure, and strategy. Mr. Adams has experience with over 2,000 transactions ranging from multi-billion dollar international conglomerates to smaller family owned and startup businesses. Transaction advisory experience includes fairness opinions, due diligence, equity structuring, debt structuring, recapitalizations, solvency opinions, acquisition consulting, board presentations, going public, going private, shareholder stock repurchases, and business planning in support of financing. Past clients include Fortune 10 to small cap public companies, private companies, and government entities including the Internal Revenue Service, Department of Defense, and the General Services Administration.

Mr. Adams frequently works to resolve shareholder disputes related to valuation and governance rights stipulated by shareholder agreements. These complex matters involve multiple classes of stock, warrants, and preference rights frequently involving different vesting, performance, or performance characteristics. Shareholder rights are an important consideration in determining the marketability and control benefits that shareholders may possess. Mr. Adams routinely counsels and quantifies clients on complex shareholder matters.

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1. START AT THE BEGINNING

Fortifying and defending your $5.12 million gifts against attack begins with recognizing appraisal weaknesses. This paper provides many tools to proactively identify appraisal weakness and strategies to turn those weaknesses into strengths. An effective appraisal is dependent on close coordination between the client, the accountant, and the attorney in order to create an accurate appraisal. Coordination will ideally begin in the planning stages of the engagement. Critically review every appraisal report and make sure that any inconsistency or omission is carefully and thoughtfully addressed in a final report. This is not a good time to rush, review from the IRS perspective. What facts will the IRS need to make an appropriate determination of value? Are those facts clearly identified? Is the conclusion consistent with these facts? Is there a story about circumstance that may clarify an opinion of value or better support conclusions? Are there legal terms or loan terms that may be obvious to those familiar with the facts but that need to be emphasized to make sure the IRS understands?

2. VALUATION ABSOLUTES

Yes, there are absolutes in valuation. There are only two ways to make money:

1. Profits Interest: This is the current income an owner has to spend in any given year. It is money after all costs. It is not taxable income, K-1, or phantom income. The Profits Interest is cash that I can freely spend as I wish without getting anyone's permission first.
2. Capital Interest: This is the return we get when we sell an asset at term end. It is cash remaining after all costs. It is not the sale price but instead the residual after paying all debts and other costs including tax. The Capital Interest is cash that I can freely spend as I wish without getting anyone's permission first.

Business appraisers must determine the present value of the Profits Interest and the Capital Interest to value any asset.

There are always buyers at a market price. Hypothetical buyers are not necessary. We can work with real buyers and real market prices. The market works, and competition eliminates pricing inefficiencies. One of the characteristics that makes the U.S. Capital markets world renown is our rule of law and commitment to meritocracy.

3. MUCKING UP THE VALUATION ABSOLUTES

There are unfortunately many ways to lose money. In an appraisal, we want to consider investment fundamentals, which include:

- Sufficient Liquidity: Do we have sufficient cash to meet operational needs? If not, can it be borrowed? If borrowed, under what terms?
- Leverage: Borrowed money needs to be paid back with interest. The time to loan expiration is a key risk factor to consider in today's market. Prior to 2008, no one worried about time to loan expiration. Think about this when drafting those long-term agreements with formulas. The markets change, and the market pricing of all assets and liabilities shifts every day.
- Pay Out Requirements: Are we required to make any distributions? Just for tax? As a percentage of assets? As a percentage of earnings? At the discretion of a Manager?
- Lack of Diversification: Is there a concentration in a single security, investment type (real estate for example), or particular geographic area, etc.
- Risk of Underlying Investments: Do we own 30-year U.S. Government bonds? They seem safe and have been great in a declining interest rate environment. I guarantee that you will lose money on this investment over the next 30 years. Money going to these bonds today is concerned about loss of principle, but really they are losing spending power assuming we have a little inflation in the next 30 years.

4. EMBRACE UNIQUENESS

We frequently find that clients have assets that naturally support and enhance the discounts that might be created through complex estate planning. Be sure this low hanging fruit is considered in the appraisal. Assets such as private equity investments, hedge funds, and partial interests in real estate all enhance discounts. To disregard it would not only be a mistake but will undermine the accuracy and, therefore, the dependability of the appraisal's results.

Many family owned businesses have a significant key person issue. The key person value can be quantified. It is effectively a discount to the otherwise unadjusted market price of the business. This hypothetical, unadjusted market price is frequently unattainable in the marketplace, especially after the death or disability of the key person.

There are many naturally occurring issues that impact the value of family-owned businesses such as licensing, zoning, contracts (or lack thereof), lack of employment agreements, environmental concerns, customer concentration, and cost of capital. These peculiarities should be identified and featured in any appraisal. They should also be measured and, when appropriate, deducted from the value of the business before consideration of any lack of control or lack of marketability adjustments.

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5. UNIQUENESS MATTERS?

These unique issues may matter a little or a lot depending on some of the typical matters addressed in company or partnership organizational documents. Most attorneys structure daily and long-term operational issues and capital issues in legal documents. Appraisers must carefully consider these written guidelines and benchmark them to optimal market structures. This process involves finding other unencumbered assets and then quantifying the value of the encumbrance. For example, I can easily buy a share of Coke and then later freely sell it for the market price. I could also put the same share in a partnership that would liquidate and distribute in one year. Let's look at an example:

An investor could have purchased a share of The Coca-Cola Company (NYSE:KO) for $37.21 on January 16, 2013. Alternatively, an investor could have purchased a one-year option in The Coca-Cola Company with a strike price of $36.25[1] and a January 18, 2014 expiration date for $2.53.

The difference in prices between a share and an option in a company approximately represents the value of liquidity for an investor. In the example above, the approximate value of liquidity to an investor is $37.21 less $2.53, or $34.68. This yields an implied liquidity discount of 6.8%

Additional companies' prices are displayed in the tables below for reference:[2]

	Dividend Paying Stocks					
	KO	**COST**	**MSFT**	**GE**	**UPS**	**Average**
Using a call option:						
Price per share	$ 37.21	$ 100.73	$ 27.15	$ 21.15	$ 79.05	
Less: Price per 1-yr ITM option	(2.53)	(7.60)	(2.17)	(2.14)	(5.30)	
Value of liquidity	34.68	93.13	24.98	19.01	73.75	
Implied liquidity discount	*6.8%*	*7.5%*	*8.0%*	*10.1%*	*6.7%*	*7.8%*
Using a put option:						
Price per share	$ 37.21	$ 100.73	$ 27.15	$ 21.15	$ 79.05	
Less: Price per 1-yr ITM option	(2.94)	(9.23)	(4.65)	(2.51)	(6.90)	
Value of liquidity	34.27	91.50	22.50	18.64	72.15	
Implied liquidity discount	*7.9%*	*9.2%*	*17.1%*	*11.9%*	*8.7%*	*11.0%*

[1] The one-year option price is for an in-the-money call option. An in the money put option for The Coca-Cola Company with a strike price of $37.50 and a January 18, 2014 expiration date would be priced at $2.94, yielding an implied liquidity discount of 7.9%.
[2] Price per share used is the opening price as of January 16, 2013. Option prices are based on option chain data as of January 16, 2013. ITM = In the money.

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	Non-Dividend Paying Stocks					
	AMZN	RIMM	GOOG	FB	WPRT	Average
Using a call option:						
Price per share	$ 270.53	$ 14.75	$ 722.40	$ 30.21	$ 27.15	
Less: Price per 1-yr ITM option	(36.15)	(3.85)	(82.16)	(5.53)	(6.90)	
Value of liquidity	234.38	10.90	640.24	24.68	20.25	
Implied liquidity discount	*13.4%*	*26.1%*	*11.4%*	*18.3%*	*25.4%*	*18.9%*
Using a put option:						
Price per share	$ 270.53	$ 14.75	$ 722.40	$ 30.21	$ 27.15	
Less: Price per 1-yr ITM option	(37.40)	(5.20)	(68.80)	(6.45)	(7.60)	
Value of liquidity	233.13	9.55	653.60	23.76	19.55	
Implied liquidity discount	*13.8%*	*35.3%*	*9.5%*	*21.4%*	*28.0%*	*21.6%*

The dividend paying examples above imply that the price of Capital Interest liquidity is lower for companies that pay current Profits Interest dividends (7.8 – 11.0% in just one year). For the non-dividend paying stocks where we do not enjoy a Profits Interest, the price of marketability is higher because we only have a Capital Interest (18.9 – 21.6% in just one year). Note that these numbers are for large SEC-regulated, freely traded securities. Obviously, a small partnership holding these same securities should trade at a higher discount even if the holding period is a single year. Industry, volatility, and other factors will also impact the actual price of marketability. The rest of this paper covers distinguishing factors the market considers.

6. WHAT SHOULD AN APPRAISAL CONSIDER?

We see many legal agreements from around the country and around the world. We excerpted sections from several agreements and generally grouped the language around key terms on which we focus in our valuations. First, let's look at the typical terms that we find addressed in legal agreements:

- Term: The length of the agreement
- Management: Who is in charge (there is always a who and never a what)?
- Profit and Loss: What happens with the money and when do I get it?
- Transfer: Can I sell? At what price can I sell? When and to whom can I sell?
- Dissolution and Termination: How long am I in this? Will it ever end?

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We attempted to order each agreement section from least restrictive to the most restrictive. The ordering could easily be changed by drafting other sections of an agreement to include terms such as "all" or "unanimous", so in the end it is the agreement AND Management intention AND the assets that result in fair market value.

7. TERM

The longer the term, the higher the discount, so the length of term and the ability to liquidate will play into the discount amount. Let us assume we do not have control. The following excerpts address term of agreements:

- The Company shall have perpetual existence.
- The Company shall continue until dissolved.
- The term of the partnership is indefinite but can be dissolved under the general partner's election.
- The term of the Company is indefinite.
- The term of the Company shall continue until dissolved pursuant to this Agreement by the Company and its members.
- The Partnership shall continue in existence until December 31, 2074 unless sooner terminated, liquidated, or dissolved by law or as provided in the Agreement.
- The shareholder agreement is to continue until death of the shareholders or dissolution.
- The term of the Partnership shall continue until terminated as provided in this agreement.
- Continues until dissolved by:
  - Any disposition by the Partnership of all its interest in the Property and mortgages thereon;
  - By mutual agreement of all the Partners; or
  - As of December 31, 2051.

If we do not have control, then almost all of these terms are very long. The only reason a rational investor will agree to such very long terms is because their interests are closely aligned. Long terms on their own are not necessarily bad, but trouble arises when long terms are combined with poor management or lack of distributions.

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8. MANAGEMENT

Management can have a significant impact on value. The worse the management, the higher the discount should be. Unfortunately, poor management routinely appears in the public markets, but poor management is more likely in the private markets. Poor managers lose money for shareholders. (Sometimes great managers also lose money). If you are an informed investor AND can sell quickly, you could potentially avoid the loss. When the term is long, however, the only recourse available is to sell at a deep discount. Therefore, an investor needs to recognize the risk of poor management and exit if possible.

Management is almost always left to the discretion of a person or group of people. These people are sometimes called a General Partner, Manager, or Trust Company. In any case, they have the ability to exercise discretion. Discretion over distributions impacts the Present Interest, and discretion over transfers, transactions, and liquidation will impact the Capital Interest.

Here are some excerpts:

- The overall management and control of the business, assets, and affairs of the Company shall be vested in the managing member and, subject to the specific limitations and restrictions set forth in the agreement.
- The managing member shall have all authority, rights, and powers generally conferred by law and shall have all the authority, rights, and powers, which it deems necessary or appropriate to effect the purposes of the Company, including, without limitation, the following:
    - To employ, contract, and deal with any persons, in connection with the management and operation of the company business;
    - To acquire, by purchase, and deal with such personal property as may be necessary, convenient or incidental to the accomplishment of the purposes of the Company;
    - To bring or defend, pay, collect, compromise, arbitrate, resort to legal action, or otherwise adjust claims or demands of or against the Company;
    - To pay as a Company expense any and all reasonable costs or expenses associated with the operation of the Company;
    - To deposit, withdraw, invest, pay, retain, and distribute the Company's funds in a manner consistent with the provisions of this agreement;
    - To borrow money and issue evidences of indebtedness in furtherance of any or all of the purposes of the Company;
    - To require in any or all Company contracts that the managing member and members shall not have any personal liability;

    - To enter into any kind of activity and to perform and carry out contracts;
    - To execute, acknowledge, and deliver any and all instruments to effectuate the foregoing.
- The managing member shall have no authority to do any of the following:
    - Act in violation of law, the project documents, or this agreement;
    - Do any act required to have the consent of the members prior to obtaining such consent; or
    - Borrow from the Company or commingle Company funds with the funds of any other person.

This manager can do almost anything and is only limited to following the law and the agreement. In some cases, the manager must get consent of the members (although not management related) and cannot personally borrow or comingle funds.

Now for a little more restriction, limit Management to removal and compensation by majority vote:

- The Managers shall have full and complete authority to manage and control the business, affairs, and properties of the Company. Initially there will be one manager and the number of managers can be determined by a majority vote. Currently Manager1 is designated as the manager. Resignation must be followed by a written notice and does not affect the manager's status as a member. Managers may be removed at any time by a majority vote with or without cause. Total compensation of the manager is determined by majority vote.

All decisions in the partnership below are made by the General Partner ("GP") and the Limited Partner ("LP") does not have any rights:

- The general partner makes all decisions relating to the Partnership's business and affairs, except as otherwise specifically provided in the partnership agreement. The general partner is authorized to engage investment advisors for the Partnership and to delegate to them full power and authority to decide upon and order sales and purchases of Partnership property.
- No person in such person's capacity as a limited partner shall take part in the management of the Partnership's business or affairs or have the right or authority to act for or bind the Partnership.

Do you want Management to consult with each member for all matters? Maybe a discount should be applied to any officer willing to take this job. No thank you, unless you also have majority ownership:

- Each Member shall be consulted with respect to all matters and decisions relating to the business and affairs of the Company. All decisions required or permitted to be made under this Agreement by the members, and all action proposed to be taken by or on behalf of the Company shall be taken, by a majority vote, by governance rights of the members unless a greater voting percentage is required by this Agreement, the Articles, or the Act. Each Member's voting power and governance rights shall be expressed as a number of units held by such Member. Each Member's units, which represent each Member's voting power on each matter subject to vote. Only members holding units shall be entitled to vote. The total number of units held by all members shall be 100 units.
- The officers of the Company shall consist of a President, a Secretary, and other officers as the members may determine from time to time. The President shall be the principal executive officer of the Company and shall supervise all of the business and affairs of the Company. At the annual meeting of the members, or as soon thereafter as is convenient, the members shall elect officers. The members may elect officers at additional times, as they deem advisable. Any number of offices may be held by the same person. A Member who is an officer shall receive no additional compensation for his or her service as an officer unless the members determine otherwise by majority vote of governance rights. The members may remove any officer at any time, with or without cause, but no such removal shall affect the contract rights of the person so removed. An officer may resign at any time by delivering written notice to the Company effective upon delivery. Future effective dates may also be used if accepted by the Company.

An example of a partnership that is lead by a Manager, except in certain situations:

- The business and affairs of the Company shall be managed by the manager. The manager shall direct, manage, and control the business of the Company to the best of its ability. Except for situations in which the approval of the members is expressly required by the operating agreement or by non-waivable provisions of applicable law, the manager shall have full and complete authority, power, and discretion to manage and control the business, affairs, and properties of the Company, to make all decisions regarding those matters, and to perform any and all other acts or activities customary or incident to the management of the Company's business. At any time when there is more than one manager, one manager may exercise all of the powers delegated to the manager in the agreement and may take any action permitted to be taken by the manager, unless the approval of more than one of the managers is expressly required pursuant to the operating agreement.

- Manager1 and Manager2 shall be the managers until the earlier of the resignation, permanent disability, or death of any of them until one of them shall serve as the sole manager.

Partnership managed by one or more Members, but written consent required for anything outside of the ordinary course of business:

- The business and affairs of the Company shall be managed by the Member. The Member shall have the power to carry out any and authorize all acts necessary or appropriate to manage the day-to-day business and administrative affairs of the Company including, but not limited to, maintaining the books and records of the Company and the Member's accounts in accordance with the provisions of the operating agreement. The written consent of the Members shall be required to take action on any business outside the ordinary course of business of the Company. Gen1 shall serve as the tax matters partner of the Company. All costs and expenses incurred by the tax matters partner in performing his duties as such shall be borne by the Company. In the event that additional members are admitted to the Company, the management of the Company shall be as provided in the amendment to the operating agreement admitting the additional members, which may provide for management of the Company by one or more managers.

As a minority investor, I have some right to withhold consent assuming the manager determines their actions are outside the normal course of the business.

Corporate GP control:

- The General Partners shall have sole and exclusive control of the Limited Partnership. The initial managing General Partner shall be Corporate1 (the "Managing General Partner"). The Managing General Partner shall have the primary responsibility of managing the daily activity of the Partnership, investing the Partnership's assets, keeping the Partnership's books, filing the Partnership's tax returns, and determining the amount or frequency of cash distributions to the Partners. Subject to any limitations expressly set forth in this Agreement, the Managing General Partner acting alone shall have the power and authority to take such action from time to time as he may deem to be necessary, appropriate, or convenient in connection with the management and conduct of the business and affairs of the Partnership.
- The Limited Partners, in their capacity as such, shall not participate in the management of the Partnership and shall have no right or authority to act for or bind the Partnership to the Partners. The Managing General Partner may receive an annual fee as compensation for acting as Managing General partner, and all General Partners shall be entitled to reimbursement for any expenses paid by them arising out of the business of the Partnership and to reasonable and customary compensation for

services, if any, rendered by a General Partner other than in his capacity as a general partner. The Managing General Partner's compensation may be adjusted annually by a majority vote, in interest not in numbers, of the Partners (including the Managing General partner). It is intended that the Managing General partner's compensation will be treated for tax purposes as a payment.

- In consideration of services rendered to the Partnership, the general partner is entitled to a management fee of 1.00% of the net asset value of the Partnership per annum. The fee is calculated and accrues monthly, and is payable in advance on the first day of each quarter. The management fee is calculated based on the net asset value of the Partnership on each monthly Valuation Date.

Knowing exactly who the person (or people) is running the Corporate GP will be important for an appraiser to understand. What is this person's relationship with the Corporate GP and will he or she be uniquely skilled to manage the assets?

A little more unusual, and definitely limiting, unless you have more than 50% mutual agreement:

- Except where expressly provided to the contrary in the Agreement, all decisions with respect to the management and control of the Partnership must be made by the mutual agreement of the Members having a more than 50% profit and loss interest as defined in the Agreement, and no acts shall be taken or sum extended or obligation incurred by the Partnership or either Member with respect to a matter within the scope of any of the major decisions ("Major Decisions") affecting the Partnership unless the same have been approved by the Members having a more than 50% profit and loss interest as defined in the Agreement. The Major Decisions shall include:
    - Acquisition of real property;
    - Acceptance of a commitment for development and/or construction financing of the Property, or borrowing money for any reason;
    - The sale, lease, transfer, or mortgaging of, or the placing of any other encumbrance on the Property, or any portion thereof, or any improvements situated thereon;
    - Making any expenditures for the development of the Property or otherwise or incurring any obligations by or of the Partnership involving a sum in excess of $500.00 for any transaction or group of similar transactions except for expenditures made and obligations incurred pursuant to a commitment or contract therefore approved by the Members;
    - Selecting or varying accounting methods and making other decisions with respect to the treatment of various transactions for federal income tax purposes consistent with the provisions of this Agreement;

  - Approval of all contracts executed by or on behalf of the Partnership, and all land plans specifications, and drawings relating thereto;
  - Determining whether or not cash of the Partnership is available for distribution and whether the same should be distributed to the Members;
  - Any other decision or action which by reason of any provision of this Agreement is required to be approved by the Members, or which, when considered prior to the making of such decisions or the taking of such action, would reasonably be expected to have a material effect on the Partnership or the assets or operations thereof, except as may be otherwise expressly provided to the contrary in this Agreement.
- Gen1 shall have the authority, responsibility, and duty to perform the following acts on behalf of the Partnership:
  - Pay from the Partnership funds all taxes, assessments, and other impositions applicable to the Property and improvements thereon and other assets owned by the Partnership.
  - Maintain all funds of the Partnership in an account used exclusively for the Partnership and in a bank or banks.
  - Cause to be prepared and furnished to each Member, within ninety days after the close of each calendar year of the Partnership, an accounting of the transactions of the Partnership for the calendar year.
  - Keep, at the offices of Gen1, all books of account and other records of the Partnership in accordance with the terms and provisions of this Agreement.
  - Prepare or cause to be prepared all tax returns of the Partnership and cause the same to be filed on behalf of the Partnership.
  - When approved by Partners having a more than 50% profit and loss interest distribute to the Partners such cash available and approved for distribution in accordance with the provisions of the Agreement.
  - Supervise all accountants and attorneys employed by the Partnership in connection with the financial affairs thereof.
  - All other services and functions, customarily performed by the financial advisor and consultant in any way relating to the financial affairs of the Partnership.

This entity is over 30 years old and owns a single piece of vacant land. Money has been assessed every year to pay property tax, insurance, and management costs. An unrelated Partner recently accepted an offer of 10% of underlying asset value to avoid the annual calls for maintenance money, which is 90% off the probable sale price for the underlying property. Being a minority

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investor in a long-term entity with a negative Profits Interest and no access to Capital Interest leads to a rational decision to sell.

9. PROFITS AND LOSSES

Now we are talking about real money. When can I spend it? Sooner is better. Let's look at a few examples. In this first case, the LP gets all the loss and the GP gets a loss only after all the LPs are losers (of course the GP shares any gains on a pro rata basis):

- The net profits of the Partnership shall be allocated to the partners in the ratio that the Partnership units of each bears to the Partnership units of all general and limited partners.
- Net losses and nonrecourse deductions shall be allocated 100% to the limited partners but only to the extent of the aggregate amount of the positive balances of the limited partners' capital accounts and no amount shall be allocated to an account in excess of the positive balance in such account prior to such allocation.
- No allocation of net loss shall be made to the limited partners to the extent that the allocation would create or increase a negative balance in the limited partners' capital account. In the event and the extent that the limited partners may not be allocated net losses, net losses shall be allocated 100% to the general partners.
- Net "book" gain and income (in excess of deductions and losses) of the Partnership resulting from a capital event, shall be allocated to the partners in accordance with the following order of priority: first, to those partners with negative capital accounts, between them in proportion to the ration of their negative capital account balances, until no partner has a negative capital account; second, to those partners whose adjusted capital contributions are in excess of their capital accounts, between them in accordance with the ratio of these excesses, until all of these excesses have been eliminated; and finally, to the partners in accordance with the ratio that the Partnership units of each bears to the Partnership units of all partners.
- Net "book" loss and deductions (in excess of income and gain) of the Partnership resulting from a capital event, shall be allocated to the partners in accordance with the following order of priority: first, to the limited partners in accordance with the ratio of their positive capital account balances, until no limited partner has a positive capital account; and thereafter, 100 percent to the general partner.

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Special allocations can be a great planning tool to shift Present Interests and Capital Interests disproportionately among generations:

- Net profits and net losses and other items of Company income, gain, loss, and deduction shall be allocated each Company year among the members as follows:
    - After giving effect to the special allocations set forth in the operating agreement, net profits for any Company year shall be allocated among the members pro rata based upon their respective Company percentages.
    - After giving effect to the special allocations set forth in in the operating agreement, net losses for any Company year shall be allocated among the members pro rata based upon their respective Company percentages.
- Managing member first:
    - Net profits or net losses for each fiscal period will be allocated among and credited to, or debited against the capital accounts of all members as of the last day of each fiscal period (i) first to the managing member to the extent of the distributions pursuant to the first step of the distributions section listed below and (ii) the balance in accordance with such member's respective ownership percentages for such fiscal period.

Disproportionate distributions are employed in most private equity funds and hedge funds (see the special section below for more thoughts on disproportionate distributions.) Here we have a 1% GP receiving 6% of the distributions; think of it as 5% off for every LP:

- Net income shall be allocated among the partners as follows:
    - First, to reverse any net losses,
    - Second, to the general partner until the aggregate net income allocated is equal to the time-based profits amount computed through the last day of the period for which net income is being allocated, and the amount of any net losses to the general partner, and
    - Thereafter, 6.0% to the general partner and 94.0% to the limited partners.
- Net losses shall be allocated as follows:
    - First to reverse any net income, as allocated above,
    - Thereafter, among the partners in accordance with their percentage interests.

A simple distribution plan…but wait not so fast. Remember the 90% off transaction? Yep, same agreement. Nothing to distribute. Not everything has to be complex to create a miserable outcome for an investor.

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- A separate profit and loss account shall be maintained for each Member.
- The Members shall share in the profits and losses of the Partnership in proportion to their pro rata interest.
- No interest shall be paid or shall accrue on the balance of any profit and loss account.

The scenario below is one where the GP is paid Present Interest first, the GP is paid Capital Interest second, and then it's a 6% GP / 94% LP split thereafter. What can make this a win-win is extraordinary investment performance. Regardless of performance, this will be a sweet deal for the GP and not so sweet for the LP:

- Net profits and losses for any period shall be computed in the same manner as the partnership reports its income for federal income tax purposes, except that for purposes of gain, loss, depreciation, and otherwise, property shall be considered to have a book value equal to its fair market value as most recently determined. The income of the Partnership exempt from tax and expenses not deductible for tax purposes shall be included in the computation. Unrealized gain or loss shall be taken into account.
- The Partnership's net profits for any period shall be allocated to the partners as follows:
    a) First, to the general partner to reverse any net losses allocated to the general partner.
    b) Next, to the general partner until the aggregate net profit allocated is equal to the sum of the time-based profits amount.
    c) 6% to the general partners and 94% to all the partners pro rata for each operations period according to the ratio of the number of partnership units owned by each partner to the aggregate number of partnership units outstanding.
- The Partnership's net losses shall be allocated amount the partners as follows:
    - To the partners pro rata for each operations period according to the ratio of the number of partnership units owned by each partner to the aggregate number of partnership units outstanding.

This language is about as simple and straight forward as it gets:

- All Partnership net profits and net losses shall be allocated to partners in accordance with their respective ownership interests.

There are many ways to allocate asset value into Present Interest and Capital Interest. All these terms are focused on this "simple" allocation. An appraiser should articulate an expected outcome for this Present Interest and Capital Interest allocation. How will money flow given the legal structure, Management intentions, and the expected underlying asset performance?

The next two sections focus more on Capital Interests, Transfer and Dissolution, and Termination.

10. TRANSFER

The right to transfer an asset freely is valuable to an owner. Legal agreements and tax rules conspire to limit transfers frequently for some very practical reasons. In any case, the limitations should be understood by the appraiser and articulated in the appraisal report. Sometimes an unauthorized transfer results in a member interest being stripped of its rights. These limited rights are sometimes referred to as substitute partner interests, economic interests, or assignee interests. Whatever they are called, the rights are far more restricted than just before the transfer that triggered the loss of rights.

Here is an interesting way to clarify what happens to those rights that are not associated with the economic interest:

Upon and contemporaneously with any sale or gift of a transferring member's economic interest in the Company which does to at the same time transfer the balance of the rights associated with the economic interest transferred by the transferring member, the Company shall purchase from the transferring member, and the transferring member shall sell to the Company for a purchase price of $100, all remaining rights and interest retained by the transferring member which immediately prior to such sale or gift were associated with the transferred economic interest.

Examples of tax reasons to not allow a transfer:

Any member may sell, transfer, assign, or otherwise dispose of all or any part of its interest without the prior written consent of the managing member. Each assignee shall automatically become a substituted member.
Unless waived by the managing member, no disposition by a member may be made if the interest to be disposed of would result in a termination of the Company under the code.

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The examples below detail scenarios where prior written consent is required and only to family in time of death. Even then, the Company has the first right of refusal at the same terms as a buyer. A potential buyer should require a breakup fee just to compensate them for the effort required to make an offer. The breakup fee will be paid by the seller and reduces the market value of the interest to all those that are not family members of existing owners.

- Unless otherwise stated in the Operating Agreement, no member shall transfer any part of his or her interest in the Company without gaining prior written consent of the members. In the circumstance of death, interest in the Company can be transferred to one or more family members but further transfer is subject to terms of the Operating Agreement. If a member desires to sell his or her interest, they must give written notice and identity the purchaser, price, terms, and conditions of the sale. The Company then has 45 days from the receipt of the notice to accept the offer. If the company does not accept the offer or does not execute the transaction on the 15th day after the expiration of the 45-day period, the selling member may execute the transaction with the prospective purchaser at the same terms given in the original written notice. If this is not executed within 60 days following the 45-day period, the terms of first refusal are re-imposed.
- Any person receiving a transfer of interest shall not be considered a member but rather an assignee of the Company interest. Assignees are only entitled to share in the allocations and distributions that they otherwise would have been entitled to as a member. Additionally assignees are not entitled to any accounting or information on transactions of the Company including reviewing Company books. Assignees can become a member if the current members accept them. Additionally the assignee would assume and agree to the terms of the Operating Agreement and pay or obligate itself to pay any and all reasonable expenses associated with being a member.

The examples below are scenarios where a GP's written consent is required for a transfer. Even if you are on great terms with the GP, a knowledgeable GP will probably turn you down. Why? Because of tax and accounting nightmares. It is much easier for a GP to have no changes to the partnership. Many larger partnerships specifically do not allow transfers to avoid the tax and accounting burdens.

- A limited partner may not transfer all or any part of the limited partner's interest without the general partner's written consent.
- In the event a limited partner receives an offer for the purchase of his or her interest, the limited partner must give notice to the general partner. Upon receipt of such notice, the Partnership has the exclusive right to purchase the interest any time within thirty days. If the Partnership chooses not to exercise this right, the Partnership shall provide the limited partner with notice of such decision not to purchase in writing.

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- If the Partnership does not elect to purchase the interest, and if the General Partner consents to the sale, the general partner shall notify the selling limited partner in writing. Subject to any prohibitions or restrictions on transfer imposed by the general partner for purposes of compliance with applicable securities law, the limited partner is free to sell within ninety days.

In the scenarios below, you cannot even withdraw voluntarily:

- Unless otherwise noted, no member shall make any transfer of any or all of his or her company interest without the prior written consent of the manager.
- A member may make a transfer of any or all of its company interest, including, without limitation, a transfer of a direct or indirect ownership interest in a member without the consent of any member if such transfer is by gift, inheritance, or will.
- Except as otherwise stated in the agreement, no member may attempt to sell, assign, transfer, or convey all or any part of his or her company interest to a non-affiliate third party without first complying with the following:
    - The selling member shall give written notice by registered mail of his or her intention to sell the offered interest to the Company.
    - The non-selling members shall respond in writing by registered mail notifying the non-selling members of the availability of the remaining offered interest.
    - If all of the offered interest is accepted on or before the expiration of the refusal election deadline by any combination of the non-selling members and the Company, then the selling member shall sell, and the purchasing parties shall purchase the offered interest.
    - If all of the offered interest is not accepted by any combination of the non-selling members and the Company on or before the expiration of the refusal election deadline, then the selling member shall be free to sell the offered interest to the third party.
- No transferee of any company interest will become a substituted member until the following conditions have been satisfied:
    - The transferor member must have executed a written instrument of transfer of such company interests in form and substance satisfactory to the manager;
    - The transferee must have executed a written agreement to assume all of the duties and obligations of the transferor member under this agreement
    - The transferor member and the transferee must have executed a written agreement to indemnify and hold the Company, the manager, and the non-

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transferring members harmless from and against any loss or liability arising out of the transfer.

  - The transferor must have delivered to the Company a written opinion of counsel for the Company or of other counsel reasonably satisfactory to the manager that such transfer will not result in (i) a violation of applicable law or this agreement, (ii) the Company being classified as an association taxable as a corporation, or (iii) the Company being deemed terminated; and
  - The transferee or transferor must have paid the expenses incurred by the Company in connection with the admission of the transferee to the Company.

- A transferee who does not become a substituted member will be entitled to receive only that portion of the distributions or allocations to which his transferor would otherwise be entitled. Such transferee will not be entitled to vote on any question regarding the Company, nor shall such transferee have the power to appoint or remove members of the board of directors and its company interest will not be considered to be outstanding for voting purposes.
- Except as otherwise set forth in this agreement, no member may, by voluntary act, withdraw from the Company.

The examples below are scenarios where written Manager consent is required and, even with Manager consent, majority approval is required to vote. This two-tier approval structure is not attractive to buyers:

- Neither a member nor an economic interest owner shall have the right to:
  - Sell, assign, transfer, pledge, hypothecate, exchange, or otherwise transfer for consideration all or any part of its membership interest or economic interest without written consent of the manager; or
  - Gift, bequeath, or otherwise transfer for no consideration all or any part of its membership interest or economic interest without the written consent of the manager.
- A transferring member may gift all or any portion of his or her membership interest and economic interest to or for the benefit of the transferring member's spouse or lineal descendants outright, into a corporation, partnership, Limited Liability Company, or in trust.
- Notwithstanding anything contained in the agreement to the contrary, if members holding a majority interest do not approve the proposed sale or gift of the transferring member's membership interest to a transferee or donee, then the proposed transferee or donee shall have no right to participate in the management of the business and affairs of the

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Company or to become a member, and the transferee or donee shall be merely an economic owner.

- Any person or entity acceptable to the manager, may become a member in the Company either by the issuance by the Company of membership interests for such consideration as the manager and the members holding a majority interest shall determine, or as a transferee of a member's membership interest or any portion thereof, pursuant to the terms and conditions of the operating agreement.

In scenarios where consent of 51% interest holders required (sometimes the 51% can not include the seller interest, as in the example below), the GP has no right to sell or transfer. We have the right of first refusal and can buy some, but not all, of the interest. Buyers hate the some not all term. Usually you want to buy all the interest, not some unknown portion. This provision also allows the remaining interest holders to buy up to a majority but no more.

On death the GP interest becomes an LP interest. This brings up the valuation moment just before or just after death argument. Our opinion? It is a tax/legal matter. Just tell us to value a GP or LP interest and we will. In fact, we can value both.

- The general partner may not assign, in whole or in part, any interest in the Partnership. Except as provided or with the consent of partners holding 51% or more of the Partnership units of all partners (excluding the partners seeking to assign their interest), no limited partner shall have the right or power to assign or transfer their partnership interest.
- Any assignment or transfer of a partnership interest shall include, but not be limited to, a subordination, encumbrance, hypothecation, gift, or collateral assignment.
- Any transfer in violation of the partnership agreement shall be void.
- If an assignment or transfer is made by a limited partner with the consent of the remaining partners, the transferee shall not become a substituted limited partner, entitled to all of the rights and privileges of the transferor, unless the transferee:
    1. Signs and accepts the terms and conditions of the partnership agreement;
    2. Satisfies the general partner that such transfer does not violate any federal or state securities laws, or might cause the termination of the Partnership; and
    3. Pays all related expenses.
- Notwithstanding the foregoing, a limited partner shall have the right and power to gift any interest in the Partnership to his or her child or children, or to a trust established for the benefit of such individuals, or to a custodian appointed under the Uniform Gift to Minors Act for the benefit of any such individuals, and shall further have the power to gift a partnership interest to a charity.

- A general partner shall have no right to sell their partnership interest. Any limited partner shall have the right to sell his partnership interest, provided that he first complies with the partnership agreement.
- The partner desiring to make the transfer shall notify the Partnership and each of the other partners. For 90 days after the notice is given, the offeree partners have the right to purchase the offering partner's entire partnership interest for the price and on the terms stated in the notice.
- Each of the offeree partners shall have the right to purchase, on the same terms, a part of the partnership interest of the offering partner in the proportion that each offeree partner's Partnership units bears to the total Partnership units of all of the offeree partners who wish to participate in the purchase; provided, however, that the participating partners may not, in the aggregate, purchase less than the entire partnership interest of the offering partner.
- If the other partners do not exercise their right to purchase the partnership interest, the offering partner, within 60 days from the expiration date for purchase by the offeree partners and on the terms and conditions stated in the notice, may sell or exchange his partnership interest to the purchaser named in the notice.
- The heirs, devisees, and legatees of a deceased limited partner shall have the rights of a transferee of a living partner.
- Upon the death of an individual general partner, such general partner's interest shall be converted into a dollar equivalent limited partnership interest.

Another theme echoed here is the buyer picks up all of the partnership expenses associated with the transfer:

- The Limited Partners will not sell, assign, transfer, mortgage, pledge, encumber, hypothecate, or otherwise dispose of all or any part of his interest in the Partnership to any person, firm, corporation, or other entity, without the written consent of the General Partners. They must furnish to the General Partners such assurances as may be requested.
- Substituted Limited Partner. In the event a Limited Partner transfers all or any part of his interest in the Partnership in compliance with the provisions above, the transferee of such Limited Partner shall have the right to become a substituted Limited Partner of the Partnership, provided that:
    a) the transferring Limited Partner has given the transferee such right;
    b) the transferring Limited Partners and his transferee execute and deliver such instruments as the General Partners deem necessary or desirable to effect such substitution;

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c) such transferee accepts and agrees in writing to be bound by all of the terms and provisions of the Agreement;

d) such transferee pays all reasonable expenses connected with such substitution; and

e) the General Partners consent to the substitution of such transferee as a substituted Limited Partner.

- In the event any of the above conditions are not met to the satisfaction of the General Partners, such transferee (including any transferee who is, at the time of such transfer, a Partner in the Partnership) shall, with respect to such transferred interest, only have the right of an assignee of an interest in a partnership, as provided under the laws of the State of Georgia.

The examples below detail scenarios where approval by a Management Company AND shareholders is required for full rights of the transferred member interest, under the condition that the buyout is at "liquidation value excluding any going concern value":

- No shareholder shall sell, transfer, assign, hypothecate, or otherwise dispose of any shareholder's shares or any rights or interest related to those shares, whether the shares are owned at the time of the shareholder agreement's signing or acquired at a later time, without the prior written consent of both the Management Company and the other shareholder. Any transfer in violation of these terms shall be null and void and without any force and effect (see Section 7 of the Shareholder Agreement).
- Upon a shareholder's death, the Company shall buy, and the estate of the deceased shareholder shall sell, all shares owned by the estate of the deceased shareholder. The purchase price for the deceased shareholder's shares shall be equal to its liquidation value. The calculation for the liquidation value is as follows:
  - The liquidation value shall be equal to one-half of the liquidation value of the company as a whole, which is equal to the sum of:
    - The amount of all outstanding loans due to the company from its shareholders; plus
    - Any interest held by the Company in ABC partnership; plus
    - The cash value of any other assets of the company, excluding any going concern value for the company; less
    - Current and long-term liabilities and adjustments included in Section 2.1(a) and 2.1(b) of the shareholder agreement.

There are also scenarios where the GP decides and LP pays or gets a deemed distribution:

- No sale, transfer, pledge, or assignment of a limited partner's interest may be made without the prior written consent of the general partner, which consent shall be granted or withheld in the sole and absolute discretion of the general partner. Any act by a limited partner in violation of the transfer provisions of the partnership agreement shall not be binding upon or recognized by the Partnership (regardless of whether the general partner has knowledge thereof), unless approved or consented to in writing by the general partner. No sale, transfer, pledge, or assignment by a limited partner of all or any part of its interest may be made to any person who does not meet the investor suitability requirements established by the general partner in its sole discretion, provide the general partner with complete subscription documents and comply with such other requirements as set forth in the partnership agreement. Each limited partner requesting a sale, transfer, pledge, or assignment of its interest agrees to pay all reasonable expenses, including attorneys' fees, incurred by the Partnership in connection with such sale, transfer, pledge, or assignment. To the extent such fees and/or expenses are not paid directly by one or more of the parties involved in such sale, transfer, pledge, or assignment, the general partner is expressly authorized to deduct such fees and/or expenses from the interest that remains after such sale, transfer, pledge, or assignment and such amounts shall be deemed to be a distribution or payment with respect to such interest.

- The samples below are scenarios where approval by 75% is required and all or nothing is required for disposal. From a buyer's perspective, we do not know if we will be able to buy it and then we must close in 60 days or the process starts over. These are not conditions that would attract any hostile buyer and the seller is left to market to a very small pool of potential buyers. These potential buyers are probably all related. Frequently, the potential buyers do not have the interest or financial wherewithal to make the purchase. These are important factors for an appraiser to consider.

- There shall be no restriction on transfers, sales, or assignments of any interests in and to the Property and/or pursuant to the Agreement which cannot be waived upon the written consent and approval of Members having more than a 75% profit and loss interest.

- No Member may dispose of less than his entire interest in the Property, nor shall he encumber or pledge his interest in the Property independent of the other Members, nor shall he dispose of his entire interest except by bona fide sale as provided herein, or by Will or interstate succession to or in trust for his or her spouse, ancestors, or descendants. In the event a Member hereto desires to sell his entire interest in the Property, he shall first offer, in writing, on the basis of the proposed sale his interest to the Members. The other Members to whom the offer is made shall have fifteen (15) days from the date of receipt of such offer to accept same in writing (all Members shall have the right to a pro rata purchase with the other Members to whom the offer is made and desiring to purchase same, or, to purchase some in such other proportion as the Member to whom such offer has been made that desire to purchase same shall agree among themselves). The rights of the said Member in and to an offer and right of first refusal are subject to the provisions herein below with respect to the option granted by each of the Members to the other set forth hereinafter in the Agreement. The closing shall be on the same terms and conditions as provided in the offer except as specifically set forth herein to the contrary. At the closing the Member shall deliver to the purchasers of his interest in the Property a warranty deed conveying a marketable title subject only to any matters affecting the Property as a whole and binding upon all the Members, and such other instruments as counsel for the purchasing Members may reasonably require, all in such form and substance as counsel for the purchasing Members may reasonably require. Notwithstanding the time for closing provided in the offer, the selling Members may not require the Accepting Members to close earlier than thirty days from the date of receipt of said offer. If the offer lapses for non-acceptance by the remaining Members, or, if all the remaining Members to whom the offer is made reject the offer, or, the offered interest is not purchased within the time provided for by the said purchase, then, the offering Member shall be free for a period of sixty days from the date of the lapse of the rights of the remaining Members to purchase same, to sell his entire interest in accordance with the terms of the proposed offer, on the basis of which it had been offered to the other Members, with terms not more favorable than proposed to the remaining Members. Any transferee of a Member's interest shall be bound by the terms of the Agreement and shall execute an instrument to that effect before the transfer. In the event the offer is not accepted by the Members to whom such an offer is made within the fifteen day period, or is rejected by said offerees and the offering Member does not close the sale to a third party within the next subsequent sixty day period following the lapse of the offer, then said right to sell shall terminate and the offer procedure provided above shall be binding and reinstituted.

11. DISSOLUTION AND TERMINATION

Dissolution is frequently a long time away and typically pro rata for a simple agreement. Note here that an election is contingent on the consent of the members. The agreement does not say ALL members, but it is implied:

- The Company shall be dissolved and its assets liquidated upon:
    - A sale or other disposition of all or substantially all of the assets of the Company;
    - The withdrawal after the date of this agreement of a managing member of the Company;
    - An election to dissolve the Company made in writing by the managing member *with the consent of the members*; or

    - Notwithstanding a breach by a member of the entry of a decree of judicial dissolution.
- The remaining assets of the Company shall be distributed pro rata to the members in accordance with their respective positive capital account balances after taking into account all capital account adjustments for the year.

Dissolution by majority vote is fine unless you are the minority. An appraiser should explore how likely a minority is to get majority control. Usually the legal structure will make becoming a majority unlikely.

- The Company shall be dissolved only by a majority vote or the death of all members. In the event of liquidation, all assets of the Company will be promptly liquidated as practicable and allocation of profits or losses will be in terms of the aforementioned distribution rights. Remaining assets will be distributed either in cash or in kind in accordance with the positive balance in each member's capital account after taking into account capital account adjustments. If distributions are made in kind, the net fair market value will be determined by an independent appraisal or by agreement of the members. No members will be required to eliminate negative balances in their capital account. Members have no recourse against any member if their capital contribution cannot be returned.

"Disabling Events" represent opportunities to continue or dissolve. This is why we ask about the age and health of partners. Much older, unhealthy partners frequently outlive expectations by a long margin. One of our clients was given 30 days to live 7 years ago. I just spoke to him last month and he was getting on a plane for some sightseeing.

- The Partnership shall dissolve and terminate upon the happening of any of the following:
    - The general partner's election to terminate the Partnership; or
    - The happening of a "Disabling Event:"
    - The death or dissolution of a general partner;
    - The Partnership filing for bankruptcy; or
    - A judicial determination that a general partner is legally incompetent.
- However, the Partnership may continue in spite of the happening of a "Disabling Event" if any other general partner is willing to continue the Partnership or within thirty days following such event, the limited partners unanimously consent to continue the Partnership and elect a new general partner.
- A reasonable time will be allowed for the orderly liquidation of the Partnership's assets in order to minimize the losses normally attendant upon such liquidation.

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There are scenarios when the Manager determines when it is time to terminate. So what is the Manager thinking about? The appraiser should have a discussion to get an understanding of timing. Are we talking about one year, ten years, one hundred years?

- The Company shall continue until the earlier of:
    - Such time as determined by the manager.
    - Notwithstanding a breach by a member of judicial dissolution.
- Upon dissolution of the Company for any reason, the Company shall promptly commence to wind-up its affairs. The Company's property and assets or the proceeds from the liquidation thereof will be applied in the following order of priority:
    - Payment of the debts and liabilities of the Company in the order of priority provided by law;
    - Payment of the expenses of liquidation;
    - Payment of any and all loans made by members or their affiliates to the Company;
    - Setting up of such reserves as the members or liquidating trustee deem reasonably necessary for any contingent or unforeseen liabilities or obligations of the Company;
    - Distribution to the members, on a pro rata basis, of the positive balances of their capital accounts, adjusted to the date of distribution; and
    - To the members in accordance with their respective percentage interests.

In partnerships that use the "All the members" clause, it just takes one member to keep things going. An appraisal should investigate the outliers, not the consensus. Who is likely to hold up the rest? We frequently consider age difference, difference in financial capacity, and prior behavior in estimating how "one" might impact "all".

- The Company shall be dissolved and its affairs shall be wound up upon the happening of any of the first to occur of the following:
    - Upon written consent of all of the members;
    - Upon the sale of all or substantially all of the assets of the Company;
    - Upon entry of a decree of final dissolution under the Connecticut Act.
- As soon as possible following the occurrence of any of the events specified above affecting the dissolution of the Company, the manager shall proceed to wind up the Company's business in accordance with the Connecticut Act.

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- If the Company is dissolved and its affairs are to be wound up, the manager shall:
    - Sell or otherwise liquidate all of the Company's assets as promptly as practicable;
    - Allocate any profit or loss resulting from such sales to the members' and economic interest owners' capital accounts;
    - Discharge all liabilities of the Company and establish such reserves as may be reasonably necessary to provide for contingencies or liabilities of the Company;
- Distribute any remaining assets in the following order:
    - If any assets of the Company are to be distributed in kind, the net fair market value of those assets as of the date of dissolution shall be determined by independent appraisals or by the agreement of the members. Those assets shall be deemed to have been sold as of the date of dissolution for their fair market value, and the capital accounts of the members and economic interest owners shall be adjusted pursuant to the provisions of the agreement to reflect such deemed sale;
    - The positive balance of each member's and economic interest owner's capital account shall be distributed to the members, either in cash or in kind, as determined by the manager, with any assets distributed in kind being valued for this purpose at their fair market value.

The provision for reserves is a common liquidation condition. Time value of money suggests that even if there is no collection risk, the delay represents a deduction or discount. Furthermore, the reason there is a reserve is that there are expected risks. An appraiser should consider the wind down costs and reserves required if termination is anticipated.

- If the Company is dissolved and its affairs are to be wound up, the Member is directed to:
    - Sell or otherwise liquidate such of the Company's assets as may be required to discharge all liabilities of the Company, including any liabilities to the Member and establish such reserves as may be reasonably necessary to provide for contingent liabilities of the Company; and
    - Distribute the remaining assets to the Member, such distribution to be made either in cash or in kind, as determined by the Member.
- Upon completing the winding up, liquidation and distribution of the assets, the Company shall be deemed terminated.

Sometimes, there are situations where there is not much flexibility on the termination timeframe. Maybe if we had unanimous agreement, one could agree to terminate earlier? Unless we are

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presented with specific facts that would suggest immanent termination, we follow the legal agreement:

- The Partnership shall be dissolved upon the occurrence of any of the following events:
  - On December 31, 2030
  - As otherwise provided by law
- Upon the dissolution of the Partnership, the proceeds from the liquidation of the assets of the Partnership and collection of the receivables of the Partnership together with assets distributed in kind, to the extent sufficient, shall be applied and distributed in the following order of priority:
  1. To the payment and discharge of all of the Partnership's debts and liabilities and the expenses of liquidation;
  2. To the creation of any reserves that the general partner deems necessary for any contingent or unforeseen liabilities or obligations of the Partnership;
  3. To the payment and discharge of all of the Partnership's debts and liabilities owing to partners, but if the amount available for payment is insufficient, then pro rata in accordance with the amounts of these debts and liabilities; and
  4. To the partners with positive capital accounts in accordance with the ratio of their capital accounts.
- The limited partners shall have no liability to the other partner or to the creditors of the Partnership on account of any deficit balance in the limited partner's capital account.
- If the general partner has a deficit balance in his capital account at the time of the liquidation of the Partnership or the liquidation of his interest in the Partnership (after crediting allocations of income and debiting allocations of loss to his capital account), the general partner must pay to the Partnership the amount of the deficit balance. The amount, upon the liquidation of the Partnership, shall be paid to the creditors of the Partnership or distributed to the other partners in accordance with their positive capital account balances.

Sometimes, different classes of partners introduce a new valuation dynamic. An increase in value for one class may come at the expense of another. An appraiser really needs to do the math not just now but anticipating various future outcomes probability weighted:

- <u>Dissolving Events</u>. The Partnership shall be dissolved, liquidated, and terminated upon the happening of any of the following events:
  a) The election by any General partner to terminate the Partnership;
  b) The happening of a "Defaulting Event"; or
  c) The happening of a "Disabling Event", unless:

i. There is any other acting General Partner willing to continue the Partnership and to act as a General Partner; or

ii. Within the ninety (90) day period immediately following the happening of such Disabling Event, the Limited Partners unanimously consent to continue the Partnership and elect a new General Partner. Upon such consent to continue the Partnership, the personal representative or beneficiary of the disabled General Partner shall be succeeded to such Partner's interest in the Partnership in the same manner and on the same terms as provided in this Agreement; provided, however, that the interest of the disabled General Partner shall hereupon be converted to the interest of a Limited Partner in the Partnership.

- Method of Liquidation. Upon the happening of any of the events specified above that require the Partnership to be dissolved, liquidated, and terminated, all of the Partnership's assets shall be applied and distributed in the following manner and in the following order of priority:
  a) To the payment of the debts and liabilities of the Partnership and to the expenses of liquidation in the order of priority as provided by law; then to
  b) The establishment of any reserves General Partners deem necessary for any contingent or unforeseen liabilities or obligations of the Partnership; provided, however, than any such reserves established by the General partners shall be paid over to a bank or other designated agent to be held in escrow for the purpose of paying any such contingent or unforeseen liabilities or obligations and, at the expiration of such period as the Partners deem advisable, of distributing the balance of such reserves in the manner hereinafter provided in this section; then to
  c) The repayment of any liabilities or debts, other than capital accounts, of the Partnership to any of the Partners; then to
  d) The Class B Limited Partners in equal shares to fulfill the remaining distribution rights, if any, granted to them above; then to
  e) The partners in proportion to the positive balances, if any, then standing in their respective capital accounts.
- Reasonable Time for Liquidation. A reasonable time shall be allowed for the orderly liquidation of the Partnership's assets pursuant to the above in order to minimize the losses normally attendant upon liquidation.
- Date of Termination. The Partnership shall terminate when all of its assets shall have been applied and distributed in accordance with the provisions above. The establishment of any reserves in accordance with the previsions above shall not have the effect of

extending the term of the Partnership, but any such reserves shall be distributed in the manner provided in such Section upon expiration of the period of such reserve.

These are the more typical categories addressed in agreements we see. Then we get the special rules.

12. SPECIAL RULES

We find many unique circumstances, and the language addressing them is not just interesting to study but can materially change the valuation outcome. For example, we could define majority ownership as a percentage ownership interest, but we also find it defined as a majority of an entity's members. So if an entity has three 1% owners and one 97% owner, then a majority can be formed by just three of the four members whose combined interest is as little as a 3%.

The following is our discussion of the valuation impact of special rules:

- There are several important factors to consider in the Investors agreement. The agreement splits the company interests into four classes. Net profits and net losses are allocated differently based on the designated company interest.

  Transfer of interests cannot be made without the prior written consent of the manager. As the Company owns real estate in a tough market, it is reasonable to assume that the agreement further hinders any transfer of an interest.

- There are several important points in the partnership that hinders the marketability of a limited partner interest. First, any limited partner transfer requires approval from the general partner. Second, distributions are not guaranteed. Limited partners may not receive distributions sufficient to satisfy income tax liabilities that may arise by virtue of their ownership of limited partnership interests. The term of the partnership is uncertain so an investor will anticipate a long holding period, decreasing marketability.
- The partnership agreement does not allow limited partners to assign or transfer their partnership interest unless there is the consent of partners holding 51% or more of the Partnership units of all partners. Additionally, the limited partners have the right and power to gift any interest in the Partnership to his children, or to a trust established for the benefit of such individuals, or to a custodian appointed under the Uniform Gift to Minors Act for the benefit of any such individuals, and have the power to gift a partnership interest to a charity. Limited partners also have the right to sell their partnership interests, provided that they first comply with the partnership agreement. We considered these factors in our concluded discounts for lack of marketability and control.
- There are several important factors to consider based on the Company's operating agreement. A member cannot transfer his or her interest in the Company without a

unanimous approval of the Class A members. As there are only two equal Class A members, this severely impacts the ability to transfer an interest. If there is a third party offer made to a member for an interest, it must first be offered to the remaining members. This limits the marketability of the Company and any buyer would consider these marketability issues when considering a purchase of an interest in the Company.

- There are several important factors to consider based on the operating agreement. Both the management and control of the Company is dependent on the managing member. The holder of a non-controlling interest will be unable to exert any type of control over the Company. Both allocation of profits or losses and distributions are skewed in favor of the managing member. Furthermore, remaining available cash can only be distributed to members at the consent of the managing member. Any transferability of interests in the Company must be approved by the managing member, which limits the marketability of the Company. There is a potential risk that further capital will be necessary to conduct the business of the Company in which case the members will be required to make an additional contribution. If any member fails to make a contribution, all ownership percentages will be recalculated to reflect the dilution of the defaulting member's interest.
- The partnership agreement allows a return on investment through distributions of net income; however, such distributions disproportionately favor the general partner. The general partner represents a 1.0% interest in the Partnership, but is entitled to receive 6.0% of net income, after net loss accounts have been reversed. The Partnership agreement states that the general partner receives 6.0% of the net cash flow and the remaining 94.0% goes to the limited partner. Currently, the general partner owns 1.0% of the Partnership and the limited partners total a 99.0% interest in the Partnership. A 99.0% limited partner would receive 94.0% of the proceeds. This is a disproportionate to the total ownership by 5.0% and results in an immediate 5.0% discount from a buyer's standpoint.
- The general partner has sole discretion over distributions, and all distributions are intended to only cover each partner's tax liability. Additionally, the partnership agreement includes several restrictions that adversely affect the value of the subject interest. The limited partners may be required to contribute additional capital, and are not able to dictate timing and amounts of distributions made by the Partnership. Furthermore, the limited partners do not have control of the management of the company and may not make transfers without the consent of all general partners.
- There are several key issues that a buyer of an interest would consider when determining the fair market value of the Partnership. There is one general partner that has sole discretion over the management of the Partnership, distributions to limited partners, and the transfer of units in the Partnership. Limited partners have no rights within the Partnership and there is uncertainty in the timing or size of any distributions. Also, a partnership interest cannot be transferred out of the direct lineal descendants of the family. This severely impairs the marketability of an interest in the Partnership.

- There are several important factors to consider based on the partnership agreement. Bagel is a general partnership, meaning that all partners are liable for any and all legal actions and debts that the Partnership may face. Also, a partner cannot transfer his or her interest in the Partnership except to anyone of a lineal descent of Bagel. If there is a third party offer made to a partner for an interest, it must be first offered to the remaining partners. This severely limits the marketability of the Partnership and any buyer would consider these marketability issues when considering a purchase of an interest in the Partnership. We considered the impact of the partnership agreement throughout our analysis.

13. DISPROPORTIONATE DISTRIBUTIONS

For instances in which Management derives a fee for managing the business, there can be disproportionate distributions in favor of Management or the General Partner. This results in a quantifiable marketability discount. The example below is taken from a partnership agreement that reflects a 5% disproportionate distribution. Almost all hedge funds, Partnership funds, and private equity funds have disproportionate distributions. Typical GP terms are 2% of assets under management each year plus 20% of capital gains (carried interest). The recent debate on the taxation of carried interests relates to taxation at ordinary income or capital gains rates. Disproportionate distributions are common in the market and have application to the estate-planning world.

- The partnership agreement allows a return on investment through distributions of net income; however, such distributions disproportionately favor the General Partner. The General Partner represents a 1.0% interest in the Partnership, but is entitled to receive 6.0% of net income, after net loss accounts have been reversed. The partnership agreement states that the General Partner receives 6.0% of the net cash flow and the remaining 94.0% goes to the Limited Partners. Currently, the General Partner owns 1.0% of the Partnership and the Limited Partners own a combined 99.0% interest in the Partnership. The 99.0% Limited Partners would receive 94.0% of the proceeds, which is disproportionate to the total ownership by 5.0% and results in an immediate 5.0% discount from a hypothetical buyer’s standpoint.

This type of structure is commonly used in alternative investment funds and is the means for the managers to derive their fee. Hedge funds, private equity funds, and Partnership capital funds use this language in their operating or partnership agreements. A potential investor must consider this direct discount to his interest as they are immediately receiving a disproportionate interest in the entity.

14. WRAPPING IT UP – REASONABLE RANGE SENSITIVITY

The following factors will affect the discounts applied to the interest being valued on a non-controlling, non-marketable basis:

Factors That Decrease Discounts	Factors That Increase Discounts
Discount for lack of Marketability	
(-) Marketable securities	(+) Disproportionate distributions
(-) Defined liquidating event	(+) Alternative investments
(-) Historical distributions	(+) Non-distributing
(-) Distributions in excess of 10% of assets	(+) Uncertainty in future distributions
(-) No debt	(+) Material amount of debt
(-) Meets public listing requirements	(+) No plans to go public
(-) Excess cash	(+) Indefinite life of entity
(-) Limited liability entity structure	(+) General partnership
(-) Larger subject interest	(+) Smaller subject interest
(-) Plans to sell the interest	(+) No plans to sell the interest
(-) A market exists for the interest	(+) No market exists for the interest
	(+) No power to liquidate
	(+) Partial interests in real estate
Discount for lack of Control	
(-) Power to acquire or liquidate assets	(+) No power to acquire or liquidate assets
(-) Unanimous consent not required	(+) Unanimous consent requirements
(-) Power to declare and pay dividends	(+) No power to declare dividends
(-) Determine management compensation	(+) No power to set compensation
(-) Ability to set policy and manage business	(+) No ability to set and manage the business

When applying a discount to a subject interest, it is important for the valuation specialist to consider the quantitative factors discussed above. Based on these factors, the overall discount will be determined subjectively using the table below. More restrictive, less marketable attributes will result in the discount range being in the lower right quadrant, and vice versa. More marketable interests, in which the owner has no control in the business, will fall in the upper right quadrant, and vice versa.

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		Control Discount				
		10.0%	15.0%	20.0%	25.0%	30.0%
Marketability Discount	15.0%	23.5%	27.8%	32.0%	36.3%	40.5%
	20.0%	28.0%	32.0%	36.0%	40.0%	44.0%
	25.0%	32.5%	36.3%	40.0%	43.8%	47.5%
	30.0%	37.0%	40.5%	44.0%	47.5%	51.0%
	35.0%	41.5%	44.8%	48.0%	51.3%	54.5%
	40.0%	46.0%	49.0%	52.0%	55.0%	58.0%
	45.0%	50.5%	53.3%	56.0%	58.8%	61.5%

15. WE DO HAVE STANDARDS – THE USPAP CHECKLIST

All valuation reports should follow the Uniform Standards of Professional Appraisal Practice ("USPAP") when completing a valuation engagement. Below is the checklist to ensure correct application of USPAP to the valuation report.

USPAP Standard	Issue	Adequate? Y	N	N/A
2-2	Reporting Option prominently stated?			
2-2(i) 1-2(a)	Client and intended users identified?			
2-2(ii) 1-2(b)	Is the Intended Use of the appraisal stated?			
2-2(iii) 1-2(e)(i)	Real estate adequately identified (including physical, legal, and economic attributes)?			
2-2(iii) 1-2(e)(iii) 1-4(g)	If personal property and / or intangibles are included in the appraisal, are they handled appropriately?			
2-2(iii) 1-2(e)(iv)	Are easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of similar nature handled appropriately?			
2-2(iv) 1-2(e)(ii)	Real Property Interest appraised stated and identified correctly?			
2-2(v) 1-2(c)	Purpose of the appraisal and definition of value included?			

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USPAP Standard	Issue	Adequate? Y	N	N/A
2-2(vi) 1-2(d)	Effective date of report included?			
2-2(viii) 1-2(g)(h)	Assumptions, hypothetical conditions, and limiting conditions reported and appropriate?			
2-2(ix)	Data, procedures, reasoning / analyses, opinions, and conclusions adequate for intended use and reporting option?			
2-2(x) 1-3(a)(b)	Highest and Best Use stated, and is the opinion adequately supported for the intended use and reporting option?			
2-3	Certification complete and signed?			
2-1(a)	Was the appraisal report clearly and accurately set forth in a manner that was not misleading?			
2-1(b)	Did the appraisal report contain sufficient information to enable the intended user to understand the report properly?			
2-1(c)	Were the extraordinary assumptions, hypothetical conditions, or limiting conditions clearly and accurately disclosed? Was the impact on value appropriately disclosed?			
1-4(a)	Sales comparison approach sufficiently analyzed (or reason for not using made)?			
1-4(b)(i)	Was the site valuation method appropriate (or reason for not using made)?			
1-4(b)(ii)	Was the cost approach adequate and supported (or reason for not using made)?			
1-4(b)(iii)	Were all sources of depreciation within the cost approach considered and appropriately analyzed?			

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USPAP Standard	Issue	Adequate? Y	N	N/A
1-4(c)(i)	Within the Income Approach (check NA if not applicable), did the appraiser analyze appropriate rental data and reasonably estimate potential gross income?			
1-4(c)(ii)	Were the operating expenses adequately analyzed within the Income Approach?			
1-4(c)(iii)	Was the capitalization rate or discount rate appropriate within the Income Approach?			
1-4(c)(iv)	Was future income and expenses based on reasonably clear and appropriate evidence?			
1-4(d)	If leased fee interest was appraised, did the appraiser appropriately analyze the effect on value of the terms and condition of the lease?			
1-4(e)	If applicable, did the appraiser analyze the effect on value of the assemblage of the various estates or component parts of a property and refrain from valuing the whole solely by adding together the individual values of the various estates or component parts?			
1-4(f)	If applicable (or known to the reviewer), did the appraiser appropriately analyze the effect on value of anticipated public or private improvements, located on or off the site, to the extent that the market actions reflect such anticipated improvements as of the effective appraisal date?			
1-5(a)	Did the appraiser analyze the current agreement of sale option, or listing of the property?			
1-5(b)	Did the appraiser analyze and report the sales history of the property (1 year for one-to-four family residential properties, and 3 years for all other property types)			
1-5(c)	Did the appraiser appropriately reconcile the approaches and analyses?			

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USPAP Standard	Issue	Adequate? Y	N	N/A
1-1(a)	Was the appraiser aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal?			
1-1(b)	Does it appear that the appraiser did not commit a substantial error of omission or commission that significantly affects the appraisal?			
1-1(c)	Does it appear that the appraiser did not render appraisal services in a careless or negligent manner, such as by making a series of errors that, although individually might not significantly affect the results of an appraisal, but in aggregate would affect the credibility of those results?			

16. CHARACTERISTICS OF A WELL-SUPPORTED VALUATION

A well-supported valuation helps reduce the risk of an IRS audit and if audited, helps the client achieve a smooth audit process. Aside from the USPAP guidance presented above, there are additional characteristics of a well-supported valuation report:

1. The inputs to the valuation agree to source documentation. A valuation specialist does not opine to the accuracy and completeness to data received but it is important that all information is documented and supportable. The starting point of any well-supported valuation starts with the source company documents.
2. Calculations are easily understood by the reader. There should not be complex calculations buried in any Excel file. The reader should be able to easily follow any adjustment made from source documentation all the way to the concluded fair market value. This ensures ease of review from the client, tax preparer and potentially an IRS representative.
3. All assumptions are clearly supported. Any assumptions need to be clearly stated and explained the report. All sources to support assumptions needs to be appropriately cited. Valuation assumptions typically have a significant impact on the fair market value and the appraiser needs to show sufficient and supportable analysis.
4. The subject interest agrees to the tax return or financial statement. The subject interest needs to be defined and clear to the reader. The concluded fair market value of the subject interest should agree to the tax return or financial statement.

5. The entire valuation report is attached to the tax return. Failure to attach the complete valuation report is one of the most significant valuation related IRS audit issues.

17. BUILT-IN GAINS LIABILITY

Because an investor would prefer to purchase an asset without incurring any contingent liabilities, a deduction for built-in gains may be appropriate prior to the application of other discounts. The real estate contributed to an entity will likely appreciate from its tax basis. Under current tax law, the capital gains tax liability for liquidation of these assets is the combined federal and state tax rate, which is anticipated to be 25% or more of the net capital gain. The net present value of the future capital gains tax liability is represented by 25% of the net capital gain[3]. The built in gains tax is unavoidable unless the tax law changes. This tax liability affects the marketability of the membership interest. A hypothetical, rational seller and a hypothetical, rational buyer of an interest in the partnership would take the entity's unrealized gains into account when negotiating the price at which such an interest would change hands. The buyers would arrive at a price that is less than the price that would have prevailed in the absence of unrealized gains.

18. FILLING IN THE BLANKS – DISCRETIONARY FACTORS NOT EXPLICIT IN PARTNERSHIP AGREEMENTS

Partnership agreements typically account for a wide array of issues that may arise. The agreement is not able to predict how the General Partner intends to manage the partnership. Below are several discretionary factors that have a significant impact on the discounts applied to the partnership:

1. Actual distributions: A distributing partnership is more marketable than one that is non-distributing. The prior five years of distributions indicate whether or not the partnership regularly distributes. If there have been past distributions but no intent in the future, this needs to be clearly understood and explained by the appraiser.
2. Investment decisions: Partnership agreements typically state that the partnership may invest or participate in anything the manager sees fit. The liquidity of the underlying asset impacts the overall marketability of the partnership. If the partnership is involved in real estate or illiquid investments such as hedge funds or private equity interests, the partnership interest is less marketable. The opposite is true for investments in marketable securities as they are readily salable. The intent to sell real

[3] Current capital gains taxes are 15% federal and 6% state for the 2012 tax year, plus a known 3.8% Obama healthcare tax beginning January 1, 2013. Federal capital gains rates are being actively negotiated for 2013 and expectations are for higher rates. Estimates for 2013 capital gains rates range from 20% to 39% and potentially more. There is little expectation of federal rates remaining at 15% in 2013. The appropriate tax rate to use is the rate that is anticipated at the potential liquidation of the Company assets. For this reason, we estimated future capital gains rates at 25%.

estate and hold marketable securities (or sell marketable securities and buy real estate) can and should flip an owner's opinion and therefore the appraiser's opinion.

3. Early liquidation: If the intent is to liquidate before the term of the partnership is up or in the near future, the marketability of the partnership increases. This needs to be understood by the appraiser in order to appropriately assign discounts. Uncertainty in liquidation and the receipt of cash leads to a higher discount.
4. Admittance of partners: If the partnership readily admits partners, the control discount could increase. Depending on the terms of the agreement, it could be harder to reach a majority vote with an increase in the number of partners. The opposite is true with few partners.

19. DISCOUNTS – WAIT JUST A MINUTE I DID NOT WANT IT THAT HIGH

The combined discount to any partnership should be carefully analyzed and supported in the valuation report. Sometimes, discounts could be higher than what is common and counsel may explicitly request that the appraiser specifically ignore certain restrictions to hedge against a potential audit. The resulting lower discount theoretically protects the client against a potential audit. Also, the creation of a margin of safety preserves the opportunity to later consider the appraiser excluded restrictions in a review or an audit.

20. MINIMUM LISTING REQUIREMENTS FOR A U.S. PUBLIC COMPANY

For some reason the IRS has argued that many Companies could be liquid if they just went public. The fact is very few companies actually successfully go public. Most Companies do not even come close to meeting the minimum listing requirements for Public markets. Today "small cap" public companies have an equity value of $1 billion or less. From a private company perspective and equity value of even $100 million is pretty big yet really not sufficient to be a good public Company. We think it is prudent to anticipate the argument. It is pretty simple to make for most partnerships.

United States stock exchanges have minimum listing requirements. The listing requirements vary depending on the exchange, and each exchange has several standards. The New York Stock Exchange has four standards. All of the conditions of one of the following four standards must be met:

1. Pre-tax income greater than $750,000, market value of public float above $3.0 million, stock price above $3.00, and shareholders' equity above $4.0 million;
2. market value of public float above $15.0 million, stock price above $3.00, two years of operating history, and shareholders' equity above $4.0 million;

3. market capitalization above $50.0 million, market value of public float above $15.0 million, stock price above $2.00, and shareholders' equity above $4.0 million; or
4. market capitalization above $75.0 million, market value of public float above $20.0 million, and stock price above $3.00.

21. IN CASE OF IRS AUDIT – CONTACT YOUR APPRAISER

If your client is audited by the IRS, it is important to contact the appraiser immediately and certainly before providing a response to questions in regards to the appraisal. Appraisers have experience working with the IRS and should assist in the preparation and review in all responses to any IRS requests. In some instances, clarification can be obtained from the IRS with minimal time and effort. Careful planning can prevent significant effort in the later stages of an IRS audit. It is always important to maintain a good working relationship with the IRS during an audit. Communication with the appraiser will help ensure an efficient resolution.

22. RESOURCES

This is what the IRS uses in their reviews: "Discount for Lack of Marketability Job Aid for IRS Valuation Professionals", September 25, 2009, Developed by Engineering/Valuation Program DLOM Team.

http://www.irs.gov/pub/irs-utl/dlom.pdf

23. CALL ME, MAYBE

These are complex matters that benefit for multiple perspectives. If in doubt, call for help. We maintain contacts with the IRS and the SEC, and have years of experience managing the valuation process required to successfully resolve disputes with the IRS. We have done work in the past for the IRS and expect to do work for the IRS in the future. We find it very helpful for all our clients to maintain a relationship with the IRS.

24. PAY THE TAX

From a valuation perspective, paying tax now removes future value from an estate and is an effective way to make a gift. We know people hate paying tax, but we can mathematically prove that paying gift tax is a good deal, assuming that the tax paid and the hypothetical investment return will be left in a taxable estate. So if your efforts to fortify and defend your $5.12 million gift fail to persuade the IRS, you can definitely get one appraiser's perspective to demonstrate that you still did good work. In the case of wealthy people, paying gift tax may be one of their best investments.

25. GIFT TAX UPDATE

There was a rush to get all transfers made in 2012 due to the uncertainty in the new tax laws and the "fiscal cliff." The gift tax exemption laws were maintained and the exemption was even increased. The basic federal gift tax exclusion amount for individuals in 2013 is $5,250,000, the Internal Revenue Service announced recently, up from $5,120,000 in 2012. The federal gift tax exclusion now is set permanently at $5 million and is indexed for inflation. But because of inflation, the amount for 2013 works out to $5,250,000. This is the same as the federal estate tax and the generation skipping transfer tax exclusion. For those that were contemplating a transfer in 2012, 2013 is as good of a time as ever.

MAXIMIZING VALUE THROUGH KNOWLEDGE

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