

## **The Ins and Outs of Valuing an FLP**

People establish family limited partnerships (FLPs) for a number of nontax reasons. One of the most common is to simplify transfer of ownership and achieve creditor protection while retaining control of assets. Another benefit of using an FLP is the ability to transfer an interest in the family business to a younger family member at a major valuation discount. The greater the discount, the lower the tax cost of the gift. Thus, properly valuing FLP interests is important for transfer tax purposes.

The concept of an FLP is simple. Family members transfer assets into the partnership, with the greatest share usually contributed by the parent. Each partner takes back a limited partnership interest, and the parent also takes back a nominal (1%) general partnership interest. The parent then gifts limited partnership interests to the kids or to trusts for their benefit.

### **Establishing Initial Value Of the FLP as a Whole**

Just as in valuing stock in closely held corporations, the first step in valuing FLP interests is to arrive at the amount that a willing buyer and seller, acting at arm's length, would agree is a fair price for the whole. This initial value is based on all facts and circumstances specific to the FLP and an objective appraisal of the assets and earning potential of the business.

An appraiser ordinarily determines the initial value before discounts based on either liquidation value or going-concern value. To derive liquidation value, the appraiser determines the value of the underlying FLP assets by netting the total value of FLP assets and liabilities, while to derive going-concern value, he or she capitalizes net earnings. The going-concern approach normally yields a lower value for the partnership, resulting in a lower gift tax cost to the transferor. Not surprisingly, the Internal Revenue Service (IRS) often challenges the use of going-concern value.

A rule of thumb is that the type of FLP assets and the nature of the FLP's business will determine which initial valuation method to use. If the FLP conducts an operating venture, the going-concern value is generally more appropriate. If the FLP looks more like a holding company, however, liquidation value is the best approach. Keep in mind that these are general rules, and basing the FLP value on some combination of those methods may be more appropriate at times.

Appraisers can apply several discounts to reduce the initial value of an FLP. The transferor may be entitled to:

- An appropriate discount if the FLP holds restricted securities,
- Another discount if the FLP owns nondiversified assets, and
- A fractional interest discount, reflecting that the holder of the interest cannot unilaterally determine the use of the partnership's assets -- although the IRS often challenges the use of this discount in the FLP setting.

### **Determining the Value Of FLP Interests**

The most common discounts an appraiser uses to arrive at the value of the transferred interest are those for lack of marketability and lack of control. The marketability discount reflects the fact that no ready market for the interest exists, making the interest illiquid. The control discount applies because an interest representing no voice in the management of the FLP is worth less than one that carries with it the right to influence the FLP's activities. The control discount should apply even if the transferee owns a majority of all interests in the FLP, provided he or she does not own a majority general partner interest. While gifts of limited partnership interests will yield valuation discounts, gifts of general partnership interests may result in valuation premiums. For example, the gift of a controlling general partner interest may result in a control premium, increasing the value of the transferred interest.

### **Beware of IRS Scrutiny**

The current climate in the IRS is to scrutinize FLPs, particularly those that consist solely of marketable securities. If a discount is the primary motivating factor, an FLP with marketable securities may not be for you. Real estate, however, can be an excellent asset with which to form an FLP. If you would like to learn more about how an FLP might work in your situation and what types of discounts could be available to you, please call us.

### **Expert Appraisal Tips**

Expert appraisals of closely held business interests are more likely to withstand IRS scrutiny. Most accounting firms can provide business valuations, but finding the right firm to meet your needs can make the process easier. Here are three tips to ensure the appraisal process goes smoothly:

- When you select an appraiser, pay attention to the type of property to be valued. Appraisers have varying amounts of experience valuing different types of property.
- Although the valuation of a closely held business is subjective and will vary from appraiser to appraiser, you need to obtain only one appraisal. A "bad" appraisal can taint or even destroy "good" appraisal or audit.
- Sitting down with your appraiser to determine the approach before he or she puts pen to paper is a good idea. The appraiser needs to understand the purpose behind the appraisal to know how to approach the job for the best result.