

## Value Your FLP Properly Or Lose the Tax Advantages

So you've decided to create a family limited partnership (FLP) to transfer an interest in your family business to your children. You'll do this by transferring assets to a partnership in exchange for general and limited partnership interests. The FLP will allow you to:

- Make potentially tax-free gifts to your children,
- Maintain some control over the assets, and
- Further reduce your taxable estate through minority interest discounts.

The prospect of a major valuation discount is especially attractive to you. You know that the greater the discount, the lower your gift tax. But you're also aware that the IRS will probably review your FLP to determine whether it has a valid business purpose. Suppose the IRS decides that you created your FLP merely to avoid tax? Then it may disregard your FLP entirely and treat all transferred assets as gifts, exposing you to significant additional gift or estate tax. So how can you properly value your FLP interests to avoid these pitfalls?

### Determine a Fair Price

The first step in valuing your FLP interests is to hire an appraiser to determine a fair price for the whole FLP. To ensure that the appraisal process goes smoothly, select an appraiser experienced with your type of business. Then explain the appraisal's purpose at the outset to obtain the best results. Finally, obtain only one appraisal. Even though the valuation of a closely held business is subjective and will vary from one appraiser to another, a "bad" appraisal can taint or even destroy a "good" appraisal on audit.

What constitutes a fair price for the whole FLP? A price that a willing buyer and seller, acting at arm's length, would agree upon. Your appraiser bases this initial value on:

1. All facts and circumstances specific to your FLP, and
2. An objective appraisal of your company's assets and earning potential.

Your appraiser determines the initial value before discounts based on either:

- Liquidation value, derived by netting the total value of FLP assets and liabilities, to determine the underlying FLP assets' value, or
- Going-concern value, derived by capitalizing net earnings.

The going-concern approach normally yields a lower value for the partnership, resulting in your owing less gift tax. Not surprisingly, the IRS often challenges the use of going-concern value.

What determines which initial valuation method your appraiser will use? Generally, the type of FLP assets and the nature of the FLP's business. If your FLP conducts an operating venture, the going-concern value is generally more appropriate. But if your FLP looks more like a holding company, liquidation value is a better approach. Remember that these are general rules -- your appraiser may appropriately base your FLP's value on a combination of these methods.

## **Apply Discounts**

To reduce your FLP's initial value, your appraiser can apply several discounts to both the value of the FLP as a whole and to individual interests. The transferor may be entitled to: 1) a discount if the FLP holds restricted securities, 2) an additional discount for owning nondiversified assets, and 3) a fractional-interest discount reflecting that the interest holder cannot unilaterally determine partnership-asset use. But beware: The IRS often challenges a fractional-interest discount in the FLP setting.

To arrive at the value of a specific transferred interest, your appraiser may discount for lack of:

- Marketability, because no ready market for the interest exists, making the interest illiquid, and
- Control, because an interest lacking a voice in your FLP's management is worth less than an interest with the right to influence FLP activities.

The control discount should apply even if the transferee owns a majority of all FLP interests, provided he or she does not own a majority general partnership interest.

On the other hand, gifts of general partnership interests may result in valuation premiums. For example, the gift of a controlling general partnership interest may result in a control premium, increasing the transferred interest's value.

## **Draft Your FLP With Care**

If you want your FLP to withstand IRS scrutiny, draft it carefully. Keep in mind that it must have a legitimate business purpose, such as to:

- Facilitate family asset retention,
- Provide for orderly asset development and management,
- Centralize asset management, and
- Protect assets from creditors' claims.

The IRS particularly scrutinizes FLPs that consist solely of marketable securities. If a discount is your primary motivating factor, an FLP with marketable securities may not be for you. But real estate can be an excellent asset with which to form an FLP.

The types of assets your FLP holds will influence the IRS. Also, if your FLP holds only publicly traded securities, for example, the IRS is likely to scrutinize the structure more than if it also holds a variety of assets, such as real estate and shares of a closely held business. Even if you can show a valid business purpose, the IRS may still review the discounts you reported on your gift tax returns to see if they are warranted.

## **Consult a Professional**

If you want your FLP to withstand IRS scrutiny, get an expert appraisal of your closely held business interests. Or just call us. We'd be glad to be of assistance in meeting your business valuation or other estate planning needs.