The Valuation of FLPs: What Does the Tax Practitioner Need to Know?

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Family limited partnerships (FLPs) have grown in popularity as an estate planning tool and a way to depress transfer tax values. Typically, a tax practitioner will ask a valuation expert to perform an analysis to determine the value of FLP interests for tax purposes. The valuation expert also prepares a report that explains the valuation method used in the analysis and why that choice of method is appropriate, as well as showing the actual calculation of the valuation amount.

Tax practitioners should be aware of the issues involved in valuing FLP interests and of how a report should be prepared because they will be relying on these valuations in the preparation of Forms 706, United States Estate (and Generation-Skipping Transfer) Tax Return, and 709, United States Gift (and Generation-Skipping Transfer) Tax Return. The better prepared the analysis and the report, the less likely the IRS is to challenge the valuation; if the IRS does challenge it, it is more likely that the dispute will be resolved in favor of the taxpayer. This article is an overview of the FLP valuation process and the things that practitioners should consider.[1]

What Is an FLP?

An FLP is a nontaxable entity that is created and governed by statute and whose partners (both general and limited) and assignees consist mainly of family members. A limited partnership is created under and governed by the Revised Uniform Limited Partnership Act (RULPA) of the state in which it is formed. Though the acts are similar in many respects across states, some features differ according to state. The FLP is also affected by various sections of the Internal Revenue Code, as is the valuation of interests in an FLP.

Many of the issues that arise in appraising FLPs become legal interpretations of the partnership agreement rather than "pure" valuation issues. Although it is important that valuation analysts know and understand the issues, it is imperative that they leave the "lawyering" to the lawyers. If there is any doubt in the valuation analyst's mind about the nature of the assignment or the terms of the partnership agreement, the client's

1 This article focuses on FLPs, but the valuation issues are very similar for family limited liability companies (FLLCs), although their legal structure is different from an FLP.

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attorney should be the one to explain it to the valuation analyst, not the other way around.

Why Are FLPs Attractive?

FLPs are particularly attractive as estate planning tools for several reasons. Through the creation of an FLP:

- Parents or grandparents can indirectly transfer interests in family-owned assets without losing control of them.
- A high degree of protection against creditors can be achieved because a partner's creditor is legally unable to gain access to the assets in the partnership.
- The assets can be kept in the family, which is an objective of many families. This can be achieved by placing restrictions on the transfer of partnership interests, especially in the event of divorce, bankruptcy, or death of a partner.
- Problems pertaining to undivided or fractionalized interests when a property is gifted to several individuals can be avoided. This can be especially important in the case of real estate properties.
- When family-owned assets are placed in a partnership, advantages can arise through economies of scale and diversification.
- A great deal of flexibility can be achieved through the partnership agreement, which can provide broad investment and business powers. These can be amended as the family's needs change, as long as all partners are in agreement.
- The partnership is a passthrough entity and does not pay income taxes.
- The gifting or transfer of an ownership interest in a limited partnership may be made at a lower value than that interest's pro-rata share of net asset value because a limited partnership interest is likely to be both noncontrolling and nonmarketable.

Documents Needed to Prepare the Appraisal Report

The practitioner should obtain the following documents in order to perform the valuation and should refer to them in the appraisal report:

- The Agreement of Partnership (or other type of business agreement, depending upon the form of the entity) and a copy of the Certificate of Limited Partnership that has been filed with the state in which the partnership was created. The certificate is an important document because it gives notice of the limited partnership's formation and the limited liability of the limited partners, and it discloses some of the partnership agreement's terms. Without this document, the IRS might not recognize the FLP.
- A list of the assets that were initially contributed to the partnership, as well as documentation about any assets that were contributed after the FLP's formation.
- Valuations of real estate and other assets held by the partnership as of the valuation date (for example, market values of marketable securities). If the partnership owns interests in other closely held businesses or partnerships, these interests must be separately appraised before the value of the LP interest can be determined.
- Financial statements and/or tax returns for the partnership for a reasonable number of years, or since inception. (If it is a new partnership, these will not exist.)
- The general partner's anticipated policies regarding distributions or a Sec. 754 election.
- If the FLP is ongoing, a history of distributions, if any, made to partners.
- Information such as minutes of meetings of partners or other documents, if they exist, may give the analyst some insight into the donor's intent at the time of the partnership's formation.

Rev. Rul. 59-60 Factors

Rev. Rul. 59-60[2] provides basic guidelines for appraising shares of closely held corporations (the IRS has extended it to apply to interests in other types of entities). Every valuation report of an FLP interest should closely follow Section 4 of Rev. Rul. 59-60, which enumerates the factors the valuation analyst should

EXECUTIVE SUMMARY

- Due to the popularity of family limited partnerships (FLPs) and the significant tax savings they can provide, the IRS has sought to limit the benefits of their use. As part of its attack on an FLP, the IRS frequently will challenge the value of the FLP that is claimed on an estate or gift tax return.
- An appraisal of an FLP is generally performed by an appraisal expert. However, because tax practitioners use the appraised value of an FLP in preparing tax returns, it is important for practitioners to know the factors that should be considered in appraising the value, the different valuation approaches and when they are appropriate, and the types of valuation discounts commonly applied in valuing an FLP.
- A properly prepared appraisal report should give details about all the factors considered in an appraisal and the particular method used to calculate the value of an FLP that a practitioner can use to support the value of the FLP claimed on an estate or gift tax return if it is challenged in an examination.

2 Rev. Rul. 59-60, 1959-1 C.B. 237.

consider in his or her valuation. The eight factors of Rev. Rul. 59-60 are:

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The stock's book value and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity of the company.
6. Whether the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market either on an exchange or over the counter.

If the analyst has not enumerated and discussed these factors in the report, he or she may not have done a thorough analysis.

In addition to these eight factors, Section 4 of Rev. Rul. 59-60 states:

> (a) . . . in general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.
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> (b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates

Exhibit: Factors to consider in valuation adjustments

- A provision (term-of-years provision) in the partnership agreement that the partnership shall continue to exist for a definite term of years, unless it is dissolved or liquidated prior to this date.
- No guarantee by the managing general partner or general partners of the return of any partner's capital contributions, any allocations of profits or losses, or any distributions of distributable cash (not even enough to cover the partners' annual taxes).
- Approval rights of limited partners required for certain major decisions; otherwise limited partners and assignees are excluded from participation in management.
- How the election of new managing general partners is accomplished.
- A provision that distances the limited partners and assignees from the FLP's assets.
- The right of the managing general partner(s) or general partner(s) to determine distributable cash.
- Capital call provision obligating partners and assignees.
- Limitations on the voluntary and involuntary transferability of general partner, limited partner, and assignee interests.
- The presence of rights of first refusal.
- Consent of all partners required for a transferee or assignee of an interest in the partnership to become a substituted limited partner.
- Whether the managing general partners or general partners are required to make a Sec. 754 election.
- Limitations on the "right" of the general partner to withdraw from the partnership prior to the expiration of its stated term and a provision that, should the general partner exercise his or her power to withdraw early, his or her general partner interest shall become a limited partner interest and he or she may also be subject to damages for breach.
- Limitations on the right of a limited partner and assignee to withdraw from the partnership prior to the expiration of its stated term.
- Provisions for dissolution of the partnership mirroring state law.

Some factors the practitioner needs to consider that may not be found in the partnership agreement include:

- The reputation, integrity, and perceived competence of the partnership management/general partner(s).
- The number of investors in the partnership.
- The type of assets owned by the partnership.
- Whether the partnership's assets are well diversified.
- The amount of financial leverage inherent in the partnership's capital structure.
- The caliber of the information flow from the partnership and the general partner(s).
- The current and historic amount of cash actually distributed to partners and assignees.
- Underlying cashflow coverage of yearly distributions made to partners and assignees.
- The size of the interest.
- The universe of interested buyers.
- The default rules under state law.

deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

The importance of this section is the guidance it provides in the selection of the methodology to use when these types of valuations are performed.

Things to Consider in the Appraisal Process

The basic characteristics of the transferred interest in the FLP, combined with specific provisions in the FLP agreement and state law, form the foundation for the valuation adjustments used in arriving at the fair market value (FMV) of the transferred interest in the FLP. Some of the factors a practitioner should consider in determining appropriate valuation adjustments may result from provisions in the partnership agreement. The exhibit on p. 40 lists some of these factors.

What About Methodology?

What is the best approach for valuing an FLP interest? Which methods can and should be used? Rev. Rul 59-60 (discussed above) seems to imply that some type of asset-based approach would be the most appropriate and, indeed, the only approach to appraising an FLP interest. Whereas an asset-based approach might be a frequently used approach to valuing such an interest, it is by no means the only one. Often an analyst may also use an income approach.

The approach the analyst uses should be determined based on the FLP's underlying assets or on whether there is a history of distributions to the partners and how extensive and consistent the distributions were. Depending on the assets held by the partnership, an analyst may also utilize a market approach. Depending on the circumstances of the case, more than one method may be appropriate.

In *Estate of Weinberg*,[3] the court accepted both an income approach and an asset-based approach for determining the value of the decedent's minority interest in a limited partnership that owned and operated an apartment complex. The court found that the taxpayer's use of the net asset value method under the asset-based approach was warranted because the property would retain most of its inherent value regardless of rental income production. Furthermore, the court found that the capitalization of the three-year average of distributions under the income approach was also appropriate. The findings of the court illustrate that the reliance on one approach (particularly the asset-based approach) for the valuation of FLPs is not always sufficient or relevant.

The use of an asset-based approach to value an FLP interest can be detrimental where the only justification for the discount amounts is the restrictions in the partnership agreement. The IRS will try to show that the restrictions are not comparable to those found in arm's-length transactions and that it should not take the restrictions into account for purposes of valuation. The IRS will then argue that if the restrictions are not valid, it should not take the partnership agreement itself into account, and therefore the limited partner interest should have a much greater value. While the IRS has not successfully argued this position in Tax Court, it has used it successfully in negotiations to pressure taxpayers to agree to higher valuation amounts. A valuation consultant may be able to complicate the IRS's attack on the discount amounts by using the market or income valuation approaches because these are not based entirely on the restrictions in the partnership agreements.[4]

Asset-based approach: Obtain the FMV of all assets and liabilities on the balance sheet and apply appropriate discounts (for lack of control and marketability).

Income approach: Determine cashflow available to partners and capitalize or discount as appropriate.[5] If a sale of the underlying assets is contemplated, the sales price might be the applicable terminal value. Apply a discount for lack of marketability (DLOM) in most cases. (No discount for lack of control is necessary because cashflow capitalized or discounted is the amount available to the minority owner; therefore, the result is a minority value.)

Market approach: Determine valuation multiples by looking for comparable publicly traded interests. The appropriate multiple could be priced to net asset value (NAV), adjusted for the risks associated with the specific valuation assignment.[6] Since these data are based on trades of minority interests, the result is a minority value. Therefore, only a DLOM needs to be applied.

Valuation Adjustments

Valuation adjustments are intended to reflect the lack of control inherent in limited partnership interests and the lack of marketability inherent in any type of closely held partnership interest. These are two separate issues that usually result in two separate adjustments or discounts. The courts recognize the need for these discounts but often disagree about what their amounts should be.

Fair market value is determined by the nature of the interest transferred. Unless the partners agree to admit the transferred interest as a partner, it is an "assignee interest." Therefore, the hypothetical willing buyer would consider it significant whether the other partners would admit him or her as a partner with all the rights that go with being a partner.

An assignee interest has only an economic interest in the partnership. That is,

3 *Estate of Weinberg*, T.C. Memo. 2000-51.

4 Fishman et al., *PPC's Guide to Business Valuations* 14-14 (Practitioners Publishing Company, 17th ed. 2007).

5 Sources of rates of return include the *Wall Street Journal*, Morningstar, and the National Association of Real Estate Investment Trusts.

6 Sources for comparable (guideline) data are closed-end mutual funds (information available from the *Wall Street Journal* and Morningstar) and Direct Investments Spectrum, published by Partnership Profiles, Inc.

he or she has a right to receive distributions, if any, and a right to distributions on liquidation. An assignee interest has fewer rights than a limited partner.

A limited partner, like a minority shareholder, does not have the ability to access the partnership assets to either manage or dispose of them. A limited partner may have little or no say in partnership management issues. And, like a minority shareholder, a limited partner does not control distributions. These are all prerogatives of management or, in the case of the limited partnership, of the general partner or the general partner who has been designated as the managing partner.

The hypothetical willing buyer most likely would not pay a liquidation price (pro rata of the underlying assets) for a limited partner or assignee interest in a limited partnership. What a willing buyer would pay would be something less than liquidation value in order to receive a return on his or her investment. This is the basis for valuation adjustments or discounts.

The analyst must read the partnership agreement carefully to determine the rights and duties of both types of partners. The limited partners' voting rights should be determined. These are the types of things that will contribute to the size of the discount for lack of control.

Discount for Lack of Control

The analyst must consider the types of assets owned by the partnership when finding a starting point for this discount. The appraiser may not need a discount for lack of control if he or she uses an income approach for this type of assignment. Although an FLP can hold almost any type of asset, most FLPs own marketable securities, real estate, or some combination of both.

Marketable securities: A logical reference point when valuing such an FLP is a closed-end investment fund. It is best to use closed-end investment funds that hold publicly traded securities that are similar to the securities held by the FLP, such as domestic stocks, foreign stocks, specialty funds, corporate bonds, municipal bonds, or government bonds. There are many other types of funds.

Typically, these funds trade at discounts to their NAVs. Statistical efforts to determine a definitive explanation for these discounts have failed to reveal a reason for the discounts. In any event, the discounts (and premiums) observed in the marketplace serve as a proxy for the lack of control discount. The reason they serve as a proxy is that holders of closed-end funds have the same lack of control over the underlying assets that a limited partner in an FLP has. It is presumed that these discounts represent the market's decrease in value for not having access to the assets and not having any control over them.

Whether the valuation analyst adjusts these discounts before applying them to his or her FLP interest is a question of the specific facts and circumstances of the particular valuation. If the analyst believes that the interest being appraised has less control, the discount may be increased, and vice versa. Another issue relates to the similarities of the portfolios. The valuation analyst might believe that his or her portfolio would trade at a higher or lower discount. Whatever position the valuation analyst takes, the discussion should include all the reasoning behind the adjustments. However, at least one Tax Court case frowned on changing the size of the discount because there were no empirical data to support the adjustment.[7]

This discount pertains only to lack of control. It has nothing to do with marketability factors. The perceived riskiness of any individual security in the FLP's portfolio will be reflected in the market value of that security. Any adjustments the analyst might be tempted to make because the partnership interest is not as easily traded as a share in a closed-end mutual fund should be avoided; that is a different discount.

There are several factors an analyst might consider in making adjustments to the starting point for the discount for lack of control. Remember that adjustments should be reasonable and reflect the facts of the particular FLP interests.

- *Professional management:* Many FLPs do not have professional management, while closed-end funds do. This would drive the discount higher.
- *Regulation:* The SEC regulates closed-end funds; the FLP investor enjoys no such protection.
- *Diversification and size:* The FLP portfolio may not have the same level of diversification as a closed-end fund. One can look at specialized funds that invest in one industry as a comparison. FLPs are often very tiny compared with closed-end funds. This might increase the discount.
- *Investment objective:* An FLP portfolio may reflect no defined investment policy or objectives. This may be a lack of professional management.
- *Quality:* Speculative versus investment grade. Recall, however, that the security's market price should reflect the market's opinion as to its overall quality. Avoid double counting in the discount.
- *Performance:* If the FLP has been in existence for a while, its total return might be compared with that of various similar closed-end funds.
- *Average maturity:* For fixed-income portfolios, average maturity of the bonds will affect their market values. Again, this factor should be addressed in the price of the security.

Real estate: Very often an FLP will hold one or more pieces of real property. These might range from the family home to vacation property (which is not recommended), vacant land, a farm, or some income-producing real property such as apartments, retail, or office space. The analyst should review these assets carefully in order to determine the nature of each because this will affect the selection of discounts.

A starting point for determining lack of control discounts for FLPs owning real estate would be real estate limited partnerships (RELPs) and real estate investment trusts (REITs). These partnerships have been in existence for a number of years, and a body of data has been accumulated on many of their features. There

7 See *Peracchio*, T.C. Memo. 2003-280.

is a fairly liquid secondary market for RELPs. It is nowhere near as liquid as a stock exchange, but enough transactions take place that there are good data on the discounts at which these securities trade to their NAVs.

According to Partnership Profiles, Inc., the discount derived using these data is primarily a discount for lack of control, but it also includes some DLOM.[8] This should be discussed in the report, and the discounts should not overlap.

Whether an FLP has a history of making distributions is an important consideration in determining the discount. Generally partnerships that make distributions trade at smaller discounts to their NAVs, all else being equal. The amount of debt is also important. If the appraisal FLP has no debt, the analyst should compare it with partnerships that also have little or no debt.

As with a discount obtained using closed-end funds, this discount for RELPs is also a starting point. It may be adjusted—either upward or downward—by factors that differentiate the appraisal FLP from the comparable RELPs. These are similar to the ones enumerated in the marketable securities section above.

Discount for Lack of Marketability

Valuation analysts often make an additional adjustment to account for the fact that there is no secondary market for FLP interests. These interests lack marketability; that is, the owner cannot liquidate them or quickly convert them to cash. If one owns shares of a publicly traded corporation, one may call a broker, sell the shares, and have the cash proceeds within a few business days. Not so with FLP interests, and this is the basis for the DLOM.

In addition to the lack of a secondary market for FLP interests, certain provisions are often written into FLP agreements restricting the transfer of interests, especially to individuals or entities outside the family circle. These restrictions create an additional lack of marketability factor. Restrictions include:

- With some exceptions, a general partner, limited partner, or assignee may not transfer all or any part of his or her interest without the prior written consent of the general partners. This consent may be given or withheld at the discretion of the general partners.
- A transferee of an interest in an FLP shall be entitled only to the rights of an assignee unless the consent of all general partners and a majority in interest of the limited partners is given to make the transferee a substitute limited partner.
- No partner or assignee shall have the right to withdraw from the FLP prior to its dissolution and liquidation.
- No partner or assignee may withdraw or reduce his or her capital contribution or capital account without the general partner's consent.

Other provisions affecting marketability: In addition to provisions in the agreement that restrict transfer, a history of little or no distribution from the FLP to the partners is a factor that affects marketability. A willing buyer might be more inclined to ignore restrictions on transfer of his or her interest in exchange for a stream of cash benefits. However, little or no distribution history is common with FLPs, which often retain income and gains in order to fulfill the long-term investment goals of the partnership.

Another factor that might affect the marketability of an FLP interest is a Sec. 754 election. This is an election that the partnership *might* make under Sec. 754, which provides that the partnership may elect to adjust the inside basis of the partnership's underlying assets. In other words, the partnership can adjust its internal books to show that a new partner paid a higher price for assets that are worth more at the time of the purchase (transfer). This election would not affect the existing partners, but it would have positive tax consequences for a new partner.

If there is nothing in the agreement that addresses the Sec. 754 election, it does not mean that the partnership cannot make the election. It still can. However, a willing buyer might wish to have assurance that such an election will be made. This is especially critical if the appraised FMV of the partnership's underlying assets has increased in value over their original basis. Since there is considerable recordkeeping involved once a partnership makes the election, an FLP may be reluctant to make the election. However, at least one Tax Court decision[9] expressed skepticism when the valuation analyst increased the discount because there was nothing in the agreement guaranteeing that the partnership would make the election. The judge stated that he did not believe a transaction would take place without the guarantee of a Sec. 754 election. In practice, though, a transfer of an interest will often take place without a corresponding election.

When valuing a general partner interest, an analyst may give some consideration to an additional marketability factor reflecting the liability exposure assumed by the general partner. Under many states' partnership statutes, a majority of the limited partners may remove a general partner that assigns all the general partner's interest in an FLP to a third party. Here the analyst must read the partnership agreement carefully to determine under what circumstances a general partner interest may be transferred or whether, after withdrawal of a general partner, that general partner interest becomes a limited partner interest. In this case, the DLOM might be increased.

An FLP can require additional capital from the partners in order to meet operating expenses and have extra capital for partnership requirements. This type of provision is not included in every FLP agreement, but its presence may warrant an additional lack of marketability factor. Capital calls might require an interest holder to remain liquid in order to meet them, rather than place funds in higher yielding but less liquid investments. A willing buyer would consider this additional liability exposure and potential loss of a more favorable investment rate of interest in determining value, and so should the valuation analyst when valuing the interest in the FLP.

8 Partnership Profiles, Inc., *2008 Executive Summary Report on Partnership Re-sale Discounts* 13–14 (2008).

9 See *Estate of Jones*, 116 T.C. 121 (2001).

Some factors that would cause an interest to trade at a low marketability discount include:

- Minimal volatility in the value of the underlying assets;
- Above-average expectations for future yield;
- A proven and stabilized history of income;
- Certainty of distributions or expectation of capital appreciation;
- Limited time period on restriction of ability to sell the interest; and
- Favorable outlook for future growth of the entity.

Factors that would cause an interest to trade at a higher discount include:

- High degree of volatility in the value of the underlying assets;
- Questionable ability to generate a satisfactory return on assets;
- Inability to generate sufficient earnings for distributions or to support future growth in operations;
- Small size in relation to other investments and lack of diversification; and
- Involvement in industries or activities viewed unfavorably by the investing public.

Other Potential Adjustments

There are several other adjustments that an analyst may make in determining a final value. Some of these adjustments may apply to the value of the underlying assets rather than to the value of an FLP interest.

Fractional interest adjustment: The FMV of an undivided ownership interest in real property is worth something less than the percentage of ownership multiplied by the FMV of the real property as a whole. Fractional interest adjustments should not be limited to undivided interests in real property but should be considered any time a fractional interest is held in any type of property. Some factors considered by the willing buyer in arriving at a fractional interest adjustment are:

- Lack of control associated with a minority interest in the property;
- Lack of marketability of a fractional interest;
- Procedural burdens, possible delays, and costs involved in severance proceedings;
- Lack of certainty as to what portion of the property would be awarded to each party upon severance;
- The nature of the property;
- The difficulty of obtaining mortgage financing for the purchase of a fractional interest;
- Declining economic conditions; and
- Loss of a major tenant.

Most real estate appraisers will not apply these fractional interest discounts. However, the valuation analyst should check the real estate appraisal, if there is one, to see if this has already been done in order to avoid double discounting.

Portfolio adjustment: The basis for a portfolio adjustment is an FLP with a nondiversified portfolio of marketable securities. In applying a willing buyer–willing seller test, the valuation analyst must decide if a willing buyer might be interested in a portfolio with a specific asset mix rather than a diversified portfolio. A portfolio containing one or two holdings might be considered more risky than one that is well diversified.[10]

Restricted securities adjustment: Restricted securities are those that are acquired from an issuer in a transaction exempt from registration requirements of federal and state securities laws (known as private placements). There are also restrictions imposed by the SEC on resales of these restricted securities. Several court cases have upheld additional discounts to account for restricted securities, but if the price of the security already reflects such a discount it should not be taken twice.

Blockage adjustment: This adjustment accounts for the depressive effect of suddenly placing a large block of stock on the market. It is expressly recognized by Regs. Secs. 20.2031-2(e) and 25.2512-2(e). Adjustments of this type are limited to blocks of publicly traded stock. It is helpful to fully document trading and volume activity in a stock for a period of time prior to the valuation date in order to justify such an adjustment.

Market absorption adjustment: This is an expansion of the blockage adjustment to take into account other assets besides stock, such as real estate, works of art, sheet music, manuscripts, books, animal mounts, and animal trophies. The basis of this adjustment reflects the lack of time within which to make an orderly disposition of these types of assets. It is possible that the sale of all the property at once or within a short space of time might result in an abrupt increase in supply of a type of asset that, with no change in demand, might reduce the price the properties could bring. The analyst should look at the number and type of assets and whether such an adjustment has been included in any professional appraisal of these assets.

Adjustment for built-in capital gains tax: Under the willing buyer–willing seller test, a valuation analyst may make an adjustment for the fact that the underlying assets may now have a market value greater than book value and that there may be a built-in capital gain for those assets. If so, a willing buyer might become responsible for capital gains tax when it sells the assets. A hypothetical willing buyer would take this into consideration when evaluating an FLP interest. This issue also is related to the Sec. 754 election.

The FLP Written Report

The next issue to consider is what should be included in the report. The eight factors

10 See *Estate of Piper*, 72 T.C. 1062 (1979).

of Rev. Rul. 59-60 should probably be included and discussed. Because the IRS is the ultimate user of the report, by including the eight factors the analyst is showing the IRS that the report has considered each of the factors laid out in the ruling. In addition, the report should include sections relating to capitalization and discount rates, if appropriate, as well as discounts and premiums.

A valuation analyst should also consider the IRS's adequate disclosure rules as stated in Regs. Sec. 301.6501(c)-1. Although these regulations specifically relate to gifts, including the same information in a report for estate tax purposes will help provide a well-supported report.

If the analyst is a CPA, he or she should consider whether the report complies with the reporting standard of Statement on Standards for Valuation Services No. 1 (SSVS 1). Although the analyst has the option of writing a detailed or summary report when performing a valuation engagement, SSVS 1 seems to steer the analyst toward providing a detailed report. The standard describes a detailed report as follows:

> The *detailed report* is structured to provide sufficient information to permit intended users to understand the data, reasoning, and analyses underlying the valuation analyst's conclusion of value. A detailed report should include, as applicable, the following sections titled using wording similar in content to that shown:
>
> - Letter of transmittal
> - Table of contents
> - Introduction
> - Sources of information
> - Analysis of the subject entity and related nonfinancial information
> - Financial statement/information analysis
> - Valuation approaches and methods considered
> - Valuation approaches and methods used
> - Valuation adjustments
> - Nonoperating assets, nonoperating liabilities, and excess or deficient operating assets (if any)
> - Representation of the valuation analyst
> - Reconciliation of estimates and conclusion of value
> - Qualifications of the valuation analyst
> - Appendices and exhibits.[11]

Conclusion

As FLPs have grown in popularity, they have drawn more and more scrutiny from the IRS. This increased attention does not mean that a practitioner needs to shy away from the use of an FLP where one is appropriate to meet a client's goals. Rather, it means that the practitioner must be more diligent in setting up an FLP to ensure that it can withstand IRS examination. As this article has noted, the IRS frequently uses the valuation of FLP interests as its point of attack on an FLP. Therefore, it is crucial that the correct appraisal methods are used to value FLP interests and that the methods are properly applied. While a tax practitioner can and most often will rely on the services of an appraisal expert to protect both the client's and the practitioner's interests, the practitioner should also have a solid understanding of the various appraisal approaches and should keep up to date on the latest developments in IRS and court decisions.

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EditorNotes

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11 AICPA Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* ¶51 (2007).