

The FLP Tax and Valuation Observer

By William H. Frazier

Beware of the appraiser advertising “conservative” valuations. An appraisal should be neither conservative nor aggressive. Rather it should reflect the appraiser’s best professional judgment as to the value. An appraiser advertising his work as “conservative” is saying: “I have built in a ‘fudge’ factor because I am not too confident in defending what I have done. I am erring on the side of the government so as to avoid an audit.”

Perhaps some are comforted by the fact that the audit risk is low because the appraiser is staying within the IRS’ unofficial safe harbor of total discounts of, say, 30 percent. (Assuming the FLP is not “deathbed” and does not have a lot of cash). But this comfort can come at an awfully steep price.

Assume Grandpa sets up an FLP with \$15 million and has \$7 million in total exclusions. (This assumes congress can get its act together and pass some legislation!) Grandma passed away a few years ago. He intends to immediately give away up to this amount to his four children. In doing the work for the gifting, appraisals of the interests must be obtained, of course. Grandpa’s tax attorney interviews two candidates for the job. The first quotes a very low fee (Grandpa is going to like that!) and proudly states he has almost never had one of his reports audited and never has any adjustments. He assures the attorney that he views everything from a very conservative viewpoint. Furthermore, he can have the report ready in two weeks—even faster if needed.

The next appraiser’s fee is not only higher, he relates that it will be at least six weeks before the final product will be completed. He tells the attorney that his reports have been audited many times but most matters were settled on a favorable basis. A few times, the controversy went almost all the way to Tax Court before settling.

In reviewing the sample reports submitted by the two appraisers, the attorney notices that the “conservative” appraiser’s report is rather brief and contains large amounts of boilerplate. The other report is detailed and appears thoughtfully prepared. Still, the attorney wonders, does it

really matter? Aren't FLP valuations commodities these days? With the discounts cited by the first appraiser, the attorney doubts the return is going to be audited. If it is, it is likely to be uncontested.

The Hard Facts in \$ and ¢

If the "conservative" appraiser was hired, the client paid a low fee for the work and the attorney received it well before he even needed it. There is virtually a zero chance of audit. (In fact, even with the "diligent" appraiser, the chance of audit on a gift tax return is low.)

Sadly, five years after the partnership is set up, Grandpa dies. Here is where the cost of the "conservative" appraisal comes back to bite the attorney and his clients.

The diligent appraiser would have determined a total discount of 37.5 percent, instead of the 30 percent determined by "conservative" appraiser. Not a lot higher, right?

But, because of the needlessly lower discount, Grandpa wound up holding more than \$1 million in partnership interests. When he died, because of appreciation, the differential had grown to about \$1.5 million. The tax bill to the estate because of going with the "conservative" appraisal is almost \$700,000!

One might suggest that I have ignored the cost of a controversy over the higher discount. The slight difference in discounts is probably not enough to evoke a major controversy. And, of course, such costs are deductible.

One might also ask: "Why doesn't the "conservative" appraiser just be a bit less conservative? The answer is: he can't because he would have to upgrade his valuation so that it would stand up in Tax Court thereby losing the price and time advantage he now holds.

Moral of the Story: *Don't be penny wise and pound foolish!*

William Frazier is the Senior Managing Director with Howard Frazier Barker Elliott, Inc.