



Promissory Notes: An Opportunity to Reduce Gift and Estate Taxes

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The current economic realities provide a window of opportunity to recognize significant gift and estate tax savings. While this article specifically addresses the benefits of transferring (either by gift or estate bequest) promissory notes secured by deeds of trust, it is also applicable to the transfer of any other type of debt instrument or asset (limited partnership interests, membership interests, equity interests, etc.) during an economic and/or real estate recession.

For gift and estate valuation, the personal representative, fiduciary or other professional advisor has the burden of providing the reported value of any promissory notes owned by the estate. IRC §20.2031-4 stipulates that the fair market value of notes - secured or unsecured - is presumed to be the amount of unpaid principal, plus interest accrued to the date of valuation, unless the taxpayer establishes that the value is lower or that the notes are worthless.

To demonstrate the savings available to a potential client on the transfer of their promissory note, let's look at the example of the "Webber" family.

Note Valuation in a Bull Market



When estimating the market value of the promissory note held by the Webbers, a business appraiser would consider the following factors:

- The date of valuation is January 1, 2009.
- On January 1, 2005, the Webbers sold 138 acres of vacant land, zoned for single-family residences, to ABC Homes for \$11 million. The property is located in an unincorporated part of Maricopa County, Arizona.
- The Webbers agreed to finance the purchase with a \$7.5 million promissory note secured by a first deed of trust. The note is equally amortized over ten years and bears interest at a rate of 7% per annum. The first installment payment was due on January 1, 2006, and the last payment is due on January 1, 2015.
- The principal balance plus accrued interest as of January 1, 2009, was \$5,955,720.
- The land was appraised for \$11 million as of January 1, 2009, indicating a loan-to-value ratio of nearly 60%.
- Based on the appraiser's analysis of the note's risk-return attributes and a survey of the secondary market for promissory notes, the appraiser concludes that a buyer of the note would require a 10% rate of return on its invested capital between January 1, 2009, and January 1, 2015 (the remaining term).

When the appraiser applies a discount rate of 10% to the future principal and interest payments, the resulting value conclusion is approximately \$4,411,000, which represents a 26% discount from the principal balance plus accrued interest due on the January 1, 2009, date of valuation.

Note Valuation in a Bear Market



Now let's take a look at the same note, but instead of a growing economic environment, we are now in the midst of a recession. The relevant facts are as follows:

- The date of valuation is January 1, 2009.
- The property was sold on January 1, 2005.
- The first installment payment was due on January 1, 2006, and the last payment is due on January 1, 2015.
- The principal balance plus accrued interest as of January 1, 2009, is \$5,955,720.
- The land was appraised for \$7 million as of January 1, 2009, indicating a loan-to-value ratio of about 85%.
- Based on a survey of the secondary market for promissory notes and the appraiser's analysis of risk return factors, he concludes that, in the current economic environment, someone purchasing the note would require a 15% rate of return.

When the appraiser applies a discount rate of 15% to future principal and interest payments, the resulting value conclusion is approximately \$3,689,000, which represents a 38% discount from the principal balance plus accrued interest due on the same date.

This example demonstrates that a 37% decline in the value of the land resulted in a 16% decline in the valuation of the promissory note.

The table below summarizes the market values of the promissory note in both bull and bear markets and calculates the gift and estate tax savings realized by the Webbers. (All figures are in thousands of dollars.)

	Principal & Accrued Interest	FMV of Note	Reduction in Reported Value	Gift Tax Savings(1)	Estate Tax Savings(2)
Bull Market	\$5,955.7	\$4,411.0	\$1,544.7	\$633.3	\$695.1
Bear Market	\$5,955.7	\$3,689.0	\$2,266.7	\$929.4	\$1,020.0

¹ Assumes a 41% federal tax rate

² Assumes a 45% federal tax rate