



# Valuation Perspectives

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## Promissory Notes: Effective Estate Planning Tools

*Often overlooked in gift and estate planning, the valuation of notes can provide opportunities for significant tax savings*

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**I**nternal Revenue Code Section 20.2031-4, Revenue Ruling 67-276, and Private Letter Ruling 8229001 provide the foundation upon which the value of secured or unsecured notes, mortgages, beneficial interests in notes or note pools, or other types of debt instruments is determined for gift and estate tax purposes.



First, 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 fiduciary establishes that the value is lower or that the notes are worthless. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that:

- the note is worth less than the unpaid amount (because of the interest rate, date of maturity or other cause), or
- the note is uncollectible, either in whole or in part (by reason of the insolvency of the liable party or for other cause) and any property pledged or mortgaged as security is insufficient to satisfy the obligation.

Second, Revenue Ruling 67-276 provides implicit guidelines for the fiduciary when rebutting the presumption that the value of the note is equal to its principal balance and accrued interest as of the date of valuation. The ruling provides that the appraiser must consider all available data and relevant

factors affecting the fair market value of a debt instrument.

Finally, Private Letter Ruling 8229001 stipulates that a discount may be allowable when valuing mortgages and notes – even in those instances in which the debt instrument is adequately secured – if the fiduciary justifies the discount in terms of low interest rate, payout terms, reliability of the obligor, etc.

### IRS Allows Discounts

While the fiduciary and its professionals carry the burden of proving the reported value, *considerable empirical data suggests that even the most commercially reasonable private promissory note has so many undesirable characteristics when compared to publicly traded debt that a discount may be appropriate.*<sup>1</sup>

When valuing notes, appraisers generally use the discounted cash flow method because it enables them to establish value by converting future anticipated benefits into value. Future principal and interest payments are discounted to present value at a rate of return commensurate with the risk factors directly or indirectly addressed in the aforementioned code section and rulings. Below are some of the risk-return attributes that should be considered by an appraiser when assessing risk and quantifying a well-supported discount rate (required rate of return).

Creditworthiness of Debtor. A direct relationship exists between the risk profile of the debtor and rate of return required by

*Continued*

<sup>1</sup>Moore, M. Read and Alan Hungate. "Valuation Discounts for Private Debt in Estate Administration." *Estate Planning*, June 1998, pp 195-203

investors. Consequently, when possible the appraiser should analyze the borrower's financial statement and calculate financial ratios in order to ascertain the debtor's ability to satisfy the payments stipulated in the note.

**Default Provisions.** Failure on the part of the borrower to make timely payments of interest and principal may result in the lender making claims against the assets of the borrower. The more stringent the default provisions, the lower the risk to the lender.

**Security.** Collateral or security provisions affect the discount rate required by investors. In general, the better claims or rights a note holder has with respect to the debtor's encumbered assets (real estate, equipment, accounts receivable, inventory, etc.), the lower the discount rate.

**Liquidity.** Since there is no established market for private notes, these types of debt instruments are not freely tradable. Investors are more willing to tie up their capital in a security that is readily marketable than in one that is privately held. Therefore, there is an inverse relationship between liquidity and required rate of return.

**Payment History.** The appraiser should track the payment history of a note to verify the timeliness and completeness of the debtor's satisfaction of its obligation. There is a direct relationship between the creditworthiness of the borrower and the size of the discount rate.

**Interest Rate and Term.** Most investors consider the uncertainty of market interest rates during the holding period to be the greatest risk

confronting them when purchasing a note. Interest rates are affected primarily by (a) the supply of money available for loans from lenders and (b) the demand from borrowers.

Furthermore, there is an inverse relationship between the remaining term of a note and an investor's required rate of return. This assertion is evidenced by the higher rates of return required by investors who purchase notes with long terms compared to debt instruments with short terms, because interest rates are much more likely to change during an extended investment horizon.

**Size of Note.** The size of a note, particularly with respect to obligations between individuals, affects its liquidity. There is an inverse relationship between the size of the principal balance of a note and the universe of potential buyers for the debt instrument.

#### Tax Savings

To demonstrate the savings that might be available to a client, assume that a decedent's estate holds a promissory note with a principal balance of \$1 million on January 1, 2008 (the date of death). The note bears interest at a rate of 7% per annum and requires the borrower to make equal installment payments beginning January 1, 2009, and on January 1 of each year over its 10-year term. When the appraiser applies a given discount rate to future principal and interest payments, the resulting value conclusion is indicated for the note. For example:

<i>Discount Rate</i>	<i>Value Conclusion</i>
10%	\$874,848
15%	\$714,560
20%	\$596,914

Now assume that the terms of the note were amended on the date of death, to require interest-only payments of 7% per annum until January 1, 2018, at which time all unpaid accrued interest and the principal of \$1 million are due and payable. Note how the indicated value conclusion decreases for each given discount rate:

<i>Discount Rate</i>	<i>Value Conclusion</i>
10%	\$780,614
15%	\$566,237
20%	\$428,061

These examples illustrate the importance of assessing risk and quantifying a well-supported discount rate based on specific risk-return factors attributable to the subject promissory note. The IRS and the tax courts expect the appraiser to exercise judgment and reasonableness in the process of evaluating the facts and determining a discount rate. When selecting a business appraiser to estimate the fair market value of a debt instrument, make sure he or she possesses the qualifications to competently identify and analyze all available quantitative and qualitative factors that relate to the underlying risk in the debt. — Gary Ringel

*Ringel Kotzin Valuation Services has valued more than 2,500 secured and unsecured notes, settlement payments and other types of debt obligations, none of which has been challenged by the IRS. We attribute our success to nearly two decades of experience and the utilization of secondary market sources to validate the reasonableness of our value conclusions. Please contact our office for further information.*