

Feature: Valuations

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Valuations of Private Promissory Notes

They're often overlooked in gift and estate tax reporting—but can provide opportunities for significant tax savings

Recent declines in the real estate and credit markets provide a unique opportunity in valuations of promissory notes.

At first blush, the fair market value (FMV) of promissory notes, secured or unsecured, appears to be easily determined. Treasury regulations presume it to be the amount of unpaid principal, plus any interest accrued to the date of valuation.

But fiduciaries can establish that the value is lower or even that notes are worthless¹—thereby reducing the transfer taxes attributable to the value of these notes. The resulting tax savings almost always exceed the cost of the appraisal.

The question, of course, is how to substantiate an alternate value so that the Internal Revenue Service is convinced.

For both estate and gift tax reporting, evidence must be submitted proving that a note is worth less than the presumed value stated in the regs. Risk factors that can reduce value include: a debtor's creditworthiness, security provisions contained in the note, collateral securing the note, as well as the note's marketability and liquidity.

Valuation Methodology

When determining the value of a note, appraisers use the discounted cash flow method, because it enables them to convert future anticipated benefits into present value. With notes, the future principal and interest payments are discounted to present value at a rate of return commensurate with the risk of default.

Appraisers begin by gathering sufficient data to ascertain if the debt instrument is worth less than the unpaid principal and accrued interest on the date of valuation. Based on the note's attributes, the valuator must request documents that evidence the obligation such as the promissory note, deed of trust, Uniform Commercial Code financing statement, security agreement, pledge agreement, guarantee, amortization schedule, etc.

The next step in the appraiser's due diligence is to gather information concerning the risk of default. Although it can be arduous and challenging to acquire a debtor's personal financial information, it's essential to ascertain the borrower's ability to satisfy future installment and balloon payments, especially if the note is unsecured. Requested data should include historical and recent tax returns, financial statements, credit reports and other relevant information.

By far, the most challenging aspect of private debt valuation, particularly when the borrower is an individual, is the correlation and quantification of risk and required rate of return—also known as the discount



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rate. A widely recognized methodology used to compute the discount rate is to quantify three components: the risk-free rate, the primary market premium and specific risk premium. The sum of these three components is the discount rate or required rate of return given the risk profile of a note.

- **Risk-free rate**—The risk-free rate is the interest rate paid by government bonds, which are considered to have little to no risk of default. The most commonly used risk-free interest rate is that paid on U.S. Treasury bonds. The remaining term of the note should be matched as closely as possible to that of the Treasury bond.

- **Primary market premium**—The primary market is the one in which transactions frequently occur and pricing information is readily available. The primary market for consumer debt, comprised of mortgages, loans secured by personal property and unsecured loans, is highly competitive, priced to incentivize home ownership and consumer spending and is more liquid due to bundling and resale opportunities available to financial institutions that are not available to individual lenders.

The difference between the interest rate charged by the primary market and the risk-free rate is the “primary market premium.” This premium compensates investors for general market risks, which include interest rate volatility, reinvestment risk and event risk.

Long-term and short-term interest rates are affected by economic factors such as economic growth, availability of and demand for credit, monetary policy, inflation and the strength of the U.S. dollar. Interest rate volatility impacts the value of notes because investors will tender an offer for a promissory note that allows them to receive a rate of return commensurate with current interest rates. Investors consider the uncertainty of market interest rates during the holding period when purchasing a note. Consequently, a direct relationship exists between the remaining term of a note and an investor’s required rate of return.

Reinvestment risk is the risk that the interim installment payments received by the holder of a promissory note may have to be reinvested at prevailing interest rates that are lower than the interest borne by the note.

Although uncommon, the ability of a borrower to make its interest and principal payments may be significantly impacted with little or no warning by event risks such as a natural disaster, terrorist attack, financial crisis or act of war. “Event risk” fears can sometimes mitigate the value of a promissory note based on the repercussions of the catastrophe.

As with the risk-free rate, the term of the proxy should be as close as possible to the remaining term of the subject note. An appraiser can obtain the applicable interest rates from either the Internet or research firms.

Also Note:

Estate tax regulations permit executors to elect to use an alternate valuation method when it would result in a decrease in the value of the estate. This election, contained in Internal Revenue Code Section 2032, permits property included in the gross estate to be valued as of the alternate valuation date (AVD) to the extent that the decline in value during the alternate valuation period is the result of market conditions.

One mistake that is often made when the AVD is elected, is that principal or prepaid interest payments made by the borrower between the date of death and AVD are used to reduce the principal balance of the note and therefore excluded from the gross estate. These payments represent includible property and should be included in the gross estate.¹

A second mistake often made is the recalculation of accrued interest. Accrued interest after the date and death and before the AVD is excluded property.²

Consequently, the principal balance and accrued interest of a promissory note held by an estate is the same on both valuation dates.

Endnotes

1. Treasury Regulations Section 20.2032-1(d)(1).

2. *Ibid.*

- **Specific risk premium**—The specific risk premium quantifies the risk-return attributes associated with a particular note and it's important to recognize that there may be a large differential between the final discount rate and the rate indicated by adding the primary market premium to the risk-free rate.

The appraiser will make adjustments to the sum of the risk-free rate and primary market premium by adding or subtracting basis points based on their analysis of the specific risk characteristics of the note.

Here are the important risk attributes applicable to the valuation of all promissory notes that appraisers should consider. Of course, additional risk attributes need to be considered based on the facts and circumstances of each note's valuation.

- **Lack of marketability**—Private notes are not freely tradable as no active market for these types of debt instruments exists. Investors are more willing to tie up their capital in a security that is readily marketable than one that is privately held. Therefore, an inverse relationship exists between marketability and required rate of return.
- **Debtor's creditworthiness**—A direct relationship exists between the risk profile of the debtor and rate of return required by investors. Consequently, the valuator should analyze the borrower's financial statements, credit rating and payment history and calculate financial coverage ratios to ascertain the debtor's ability to satisfy the payments stipulated in a note.
- **Security provisions**—Security provisions delineate the rights and recourse available to the lender should the borrower not comply with the terms and conditions set forth in the loan agreement. For instance, the provisions may stipulate requirements a lender has of the borrower to maintain specific financial conditions which help to mitigate the risk of default.
Covenants may prescribe specific financial coverage ratios, trigger repayment of the note upon the sale of a specific asset, assess late fees and penalty interest or result in the lender making claims against the borrower's assets. The more stringent the security provisions, the lower the risk to the lender and the lower the required rate of return.
- **Collateral**—In general, the better claim or right a note

holder has with respect to the assets the debtor has offered as collateral, the lower the discount rate. This is because the lender has alternative sources for collection should the borrower default.

The quality of the collateral also has an impact on the discount rate. There is a direct relationship between the quality of the collateral and required rate of return. Factors that impact the quality of the collateral include lien position, loan-to-value ratio (equity) and liquidity.

Market Survey

Revenue Ruling 67-276 stipulates that a market survey, which solicits bids from the secondary market, will not be accepted as conclusive evidence of FMV. Still, it's an important tool for an appraiser to use to demonstrate the reasonableness of the value as determined by the discounted cash flow method. A thinly traded informal secondary market comprised of sellers, buyers and brokers provides limited liquidity for unsecured and secured promissory notes. To obtain these offers the valuator submits all data collected to brokers or investors who purchase private debt. The brokers or investors in turn perform their own independent analysis, then return offers to the valuator.

It's important to remember that the secondary market bids represent the price a buyer would pay for the note. The valuator also must consider whether the bids represent a price at which the note holder would be motivated to sell. Failure to consider this important issue can lead to an undervaluation of the note.

Tax Court Response

The Tax Court has upheld the application of discounts for promissory notes in a number of cases. Judgments made that reduced or eliminated discounts were largely due to the failure of the fiduciary, and by extension the valuator, to substantiate with sufficient evidence that a discounted value is appropriate.

The judges rendering these judgments frequently cited the credibility of the appraiser, completeness of the analysis as presented in the appraisal report, and oral arguments submitted at trial. If appraisers or their reports are deemed to be inadequate by reason of experience, thoroughness and accuracy of analysis or

any number of other factors, a judge often completely disregards the report and largely accepts the value presented by the appraiser it deems most credible.

Tax Savings

A little discount can go a long way in tax savings. For example:

Assume that the holder of a promissory note died on Jan. 1, 2009. The seller carry back note was originated upon the sale of a residence that was sold on Jan. 1, 2000 for \$1.25 million. At the close of escrow, the borrower paid \$250,000 and executed a promissory note for \$1 million, which was secured by a first deed of trust. The note bears interest at a rate of 7 percent per year and requires the borrower to make principal and interest payments of \$109,795 beginning Feb. 1, 2001 and on the first of February of each year over its 15-year term. The note contains a default provision stipulating that if payments are not received within five days of the due date, a 10 percent late fee is assessed.

An appraisal for the home was provided that indicated an FMV of \$1 million as of Jan. 1, 2009. The valuator was provided with documentation indicating that the borrower had made all required payments on the note in a timely manner and that the borrower's creditworthiness indicated a low default risk. The outstanding principal balance as of the date of death was \$591,715 and accrued interest was \$37,968.

Based on the analysis of the collected data, the appraiser calculates the discount rate as follows:

- the risk-free rate = 2.23 percent;
- the primary market premium = 3.51 percent;
- the specific risk premium = 9.26 percent; and
- the resulting discount rate is 15 percent.

While performing this analysis, the valuator submitted the collected information to a broker who was asked to solicit bids for the note. The market survey returned an average offer of \$503,746, which indicates a required rate of return of 16.35 percent, demonstrating the reasonableness of the appraiser's 15 percent discount rate.

As this example shows, even the application of a modest discount rate of 15 percent, when applied to the future principal and interest payments, results in tax savings of \$49,807. This savings is based on a value conclusion of \$519,000 (rounded to the nearest thousand), which is indicated for the note and a combined federal and state estate tax rate of 45 percent.

Go For It

These are times of economic uncertainty, but professionals need to recognize that the very factors causing concern—increased credit defaults, bankruptcy, declining real estate values, unemployment, sluggishness in the credit markets—are the same factors that allow appraisers to value a promissory note at less than the outstanding principal and accrued interest. Most private promissory note appraisals cost a few thousand dollars, but result in meaningful tax savings to the client. The worst the IRS will do is say, “No.” **TE**

Endnote

1. Treasury Regulation Sections 20.2031-4 and 25.2512-4 govern the valuation of secured or unsecured notes, mortgages, beneficial interests in notes or note pools, or other types of debt instruments for estate and gift tax purposes.

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