When a Reduced Value is a Good Thing

By Joe Luby, CFP

High-net-worth clients want their assets to be worth a little for tax purposes but worth a lot for spending purposes. Applying strategic valuation adjustment principles can accomplish both priorities with excellent results.

Valuation adjustment principles are factors that, when applied to an asset, or found inherent in an asset’s design, cause the fair market value (FMV) to increase or decrease relative to its net asset value (NAV). When FMV increases, the asset is said to be valued at a premium. When FMV decreases, the asset is valued at a discount. More often than not, valuation factors result in a discounted FMV providing significant opportunity for tax planning. The following list includes common valuation factors that typically cause a decrease in FMV:

Lack of control (minority interest). An investor holds a minority position in an asset, most commonly a limited partnership (LP) or limited liability company (LLC). The minority interest holder does not have a controlling vote and thus cannot control the direction of the company.

Lack of marketability. Assets have no ready market for their shares/units/interests to be bought and sold such as a stock exchange. If an investor cannot readily sell his or her interests on a liquid exchange with easy-to-obtain bid/ask quotes and spreads, then said interests suffer from a lack of marketability.

Lack of liquidity. Assets that suffer from either or both of the factors above and do not provide any form of dividend, interest, profit distribution, or other cash payout have a lack of liquidity. They are hard to convert to cash and they don’t produce any income for immediate use by the owner.

Built-in capital gains. This issue generally is found in C corporations with substantial built-in capital gains tax liabilities. The buyer of these assets assumes the tax obligation that will be incurred when the corporation liquidates the low-basis asset(s) realizing the built-in gain.

Fractional interests. Fractional interests refer primarily to real estate holdings where the investor does not own 100 percent of the property. Ownership is often as tenants-in-common.

Assignee status. Secondary recipients of most LP and LLC interests usually become assignees rather than full partners or members of the company. Their status may change to that of full partner/member depending on whether the company has a provision and method for doing so. Assignees do not share the same rights as partners and members.

Blockage/market absorption. This factor most commonly refers to things such as art and collectibles but can refer to real estate in some situations. It describes a discount to be applied when flooding the market with a certain type of asset would cause a significant drop in prices.

Valuation adjustment comes into play when evaluating nonpublicly traded assets such as private business stock, real estate, partnership holdings, LLC interests, and other hard-to-value assets. These types of investments generally are subject to one or more of the factors listed above, all of which must be considered when determining the appropriate FMV.

Consider closed-end mutual funds trading on the exchange. They usually have two values: NAV and FMV.

The NAV represents the underlying portfolio value divided by the total number of shares outstanding, a very straightforward calculation. The FMV, however, is subject to valuation adjustment principles dependent upon current trading activity. For example, the FMV may be higher than the NAV (trading at a premium) or lower than the NAV (trading at a discount). The valuation adjustment occurs automatically in the marketplace via the trading activity and bid/ask prices.

Applying valuation adjustments to nonpublicly traded assets is similar except that instead of real-time market changes reflecting the appropriate discount or premium to be applied, an appraiser is retained to perform a valuation analysis of the asset. The appraiser must consider all relevant factors in determining FMV. For example, when valuing real estate parcels, recent sales of similar properties in the area are relevant for comparison purposes. Strict provisions regarding the transfer and resale of LP or LLC interests are relevant factors for an appraiser to consider in those investments. Here is the Internal Revenue Service and court-accepted definition of FMV: “The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.”

The tax benefits from using assets subject to these principles can be astonishing. In many cases, clients already hold assets subject to these types of valuation adjustments and don’t realize it. Hedge funds, private equity funds, private real estate investment trusts, and other alternative asset class investments often have discount valuation principles inherent in their design.
Another way to apply discounting factors is through the use of family limited partnerships (FLPs) and family limited liability companies (FLLCs). In each instance, a family establishes a new company and funds it with existing assets. Minority interests in the FLP or FLLC then are gifted and/or sold to next-generation family members (children and grandchildren) or trusts for their benefit. By applying discount valuation principles to the FLP/FLLC interests, the net value gifted or sold is much less than the actual NAV, causing an immediate tax savings.

For example, assume I own a 25-percent interest in a partnership that operates a popular ice creamery. My three other partners each own 25 percent and the entire operation has a $1-million NAV. My partners and I are old high school and college chums. Business is good, but I want to sell my 25-percent stake and move on. I offer it to you for sale at the NAV price of $250,000. Do we have a deal? Not likely. What are you really buying? A minority interest (lack of control) in a company that is privately held with no public market to sell your interest (lack of marketability) that is not required to produce any income or profit distributions to you on any particular time schedule and that you cannot force to liquidate assets to generate cash (lack of liquidity). You know nothing about ice cream except your favorite flavor, and your three new partners are best friends from way back who don't know you from Adam and always can outvote you.

Let’s say after much discussion we agree to a price of $175,000. We have just set the FMV at $175,000 with a NAV of $250,000 (30-percent valuation adjustment or discount). That’s exactly what happens with the closed-end fund described above except those negotiations take milliseconds on the exchange via bid/ask spreads.

Now assume I’m doing my personal financial and estate planning and want to transfer my interest in the business to a trust for my children’s future benefit. Which value do I use? I am required to use FMV when reporting gifting transactions. Thus my gift to the trust is valued at $175,000, not $250,000. This makes a huge difference when calculating any gift tax due on that transaction. The only difference is that in the gift transaction there is no buyer to negotiate with to come up with that $175,000 figure. That’s where the appraiser comes in. I would need to hire an appraiser to do the valuation analysis wherein he/she would look at all the facts and determine what the hypothetical willing buyer and willing seller would agree to for my 25-percent interest in the company.

The following are some examples that show when high-net-worth clients can gain significant tax benefits from having an asset subject to a discount valuation adjustment.

**Example 1: Roth Conversions**

Converting a traditional individual retirement account (IRA) to a Roth IRA results in taxable income to the IRA owner in the year of the conversion. The FMV of the converted assets is reported to the IRA owner via Form 1099R provided by the IRA custodian. Note that the custodian is required to report the FMV of the converted assets.

Assume the same business facts as above except that I own my 25-percent interest in the ice creamery in my IRA. When I do my Roth conversion, the total taxable income will be the reduced value of $175,000 even though the underlying value of the asset is actually $250,000. Let that sink in for a minute.

Maybe you or your client haven't considered a Roth conversion because of the tax bill or the fear that the client will be in a lower tax bracket later in life and could have saved money by holding the traditional IRA. What if you could reduce the federal tax bracket on the conversion to less than 25 percent? That's exactly what happens on a large Roth conversion where the IRA is holding an asset discounted 30 percent. Here is how it works:

1. $1-million traditional IRA
   - 30% valuation adjustment (discount) = $700,000 FMV
   - $700,000 FMV × 35% top federal tax bracket = $245,000
   - $245,000 federal tax / $1-million NAV = 24.5% effective tax rate

How many high-net-worth clients are likely to be in a tax bracket lower than 24.5 percent later in life? Not many. This makes the Roth conversion incredibly attractive even for some who otherwise might balk at the tax bill.

**Example 2: Intrafamily Sale/Loan Transaction**

Wealth transfer situations often call for discounted assets to be gifted in order to reduce the applicable gift tax (or future estate tax) consequences that otherwise would result. An intrafamily sale and loan transaction is even more attractive given today's interest-rate environment.

For example, Mother would like to transfer assets to Son but doesn’t want to pay gift tax. She either has used up her lifetime exemption or is using it in other strategies. A simple solution is to sell assets to Son at their discounted FMV in exchange for a promissory note. Let’s assume that Mother owns shares of a private investment fund (PIF) with NAV of $1 million and FMV of $700,000. Mother sells her PIF shares to Son for their full FMV of $700,000 taking back an interest-only promissory note for the purchase price. The term on the note is five years and the interest rate is the midterm applicable federal rate (AFR) in effect at the time of the note. Using the April 2011 AFR tables, the interest on the note would be only 2.49 percent.

Son makes interest payments to Mother during the term with a balloon payment due at the end of five years.
of 2010, t
In addition to the new tax-related laws
on Family Offices
Dodd-Frank Act Impact

$1 million cash to pay off the $700,000
change in PIF value. Son now has
the five-year note term and assume no
change in the PIF value. He pockets the $300,000 difference
completely free of gift tax. Any growth
of the underlying PIF asset beyond the
annual 2.49-percent interest on the note
also accrues to Son gift-tax free.

The same transaction can be
accomplished using a trust for Son’s
benefit as the buyer if Mother doesn’t
want the cash to go directly into Son’s
hands for any number of reasons
including asset protection, spendthrift
protection, etc.

Valuation adjustment, or discount
valuation as it often is called, is a very
powerful technique for reducing the
tax bill on many different transactions
for wealthy clients. These strategies are
commonly used in the gift and estate
tax realm.

A newer and more widely
applicable technique is to use a private
investment fund that applies the same
discounting principles such as lack of
marketability and lack of control to a
more traditionally styled investment
fund portfolio. Such funds typically
have investment objectives, portfolios,
and managers that are similar to
traditional mutual funds or separately
managed accounts. They are also
usually IRA compliant, unlike most
family business structures, which makes
them particularly attractive to large
retirement account owners.

Conclusion
So clients actually can benefit greatly
from a substantial drop in asset values.
Just make sure you help them engineer
the valuation adjustment in a controlled
manner instead of having them do it at
the roulette wheel, trading penny stocks,
investing in underwater offshore gold
mines, or any other method where the
adjustment is likely to be permanent.

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Endnote
1 Treasury Regulations Section 25.2512-1,
20.2031-1(b) and Revenue Ruling 59-60,
1959-1 C.B. 237.