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The Importance of Understanding Valuation in Estate, Business and Financial Planning

Property valuation can be a key component of an estate, business or financial plan. The reality is that many types of assets are not that easy to value (e.g., real estate or a business) but yet, the effectiveness of a well designed plan may depend upon the value of the asset. Individuals or business owners who do not understand the importance of valuation can find themselves in for a rude awakening, resulting in unforeseen taxes, IRS audits, inadequate retirement savings, and otherwise shortchanging themselves or their families. To help you better understand why valuation is critical, let's briefly look at 10 common situations.

1. Planning for Estate Taxes. All property owned by a decedent is disclosed by the executor on the estate tax return (Form 706) at "fair market value". In general, fair market value is roughly defined as what a willing buyer would pay a willing seller in an arm's length transaction. The problem is that some types of property are difficult to value, and obviously, the IRS would prefer a higher value to increase taxes. Items that may need to be valued by a professional appraiser include: real estate, a business, jewelry, art work, collectibles, furniture, and personal property.

For a business, the IRS uses many factors to determine fair market value such as: (a) the value set forth in a binding buy-sell agreement; (b) recent sales of comparable businesses; (c) good will; (d) book value; (e) formulas based upon revenue and projected earnings; and (f) general economic conditions. Note, however, that in situations involving a family business, the IRS takes an even closer look at various factors. The price set forth in a buy-sell agreement among family members may be completely disregarded by the IRS, when valuing a decedent's business interest. The IRS may view the sale as a disguised way to transfer property to a family member at a reduced price, rather than at fair market value.

The executor is also required to attach to the estate tax return, the past 5 years of financial statements of the business. Improper valuation could lead to an IRS audit, a claim for additional estate taxes, interest, penalties, and possibly, litigation.

2. Lifetime Gifting. Gifts of property are generally made to reduce the size of an individual's estate or to freeze values. Typical gifts are characterized as "present interest" gifts. That means that the recipient of the gift exercises complete control and enjoyment of the property that was gifted, immediately after the gift. For example: John gives $5,000 to his daughter Cindy with no strings attached. Cindy can do whatever she wants with that money. This is considered a present interest gift. Suppose however, that Cindy can't touch the money until 5 years from now. Cindy does not have immediate use and enjoyment of the gift. This would be considered a "future interest" gift.

All gifts are generally "taxable gifts" unless the gift is present interest falls within a dollar amount that the person making the gifts (the "donor") can give each year to as many people as s/he wants (each called a "donee"), without gift tax consequences. This is known as the annual gift tax exclusion gift (for 2015, $14,000 per year per donee). Over and above this amount, each person can gift a certain amount, in the aggregate, without current gift taxes. That amount is the lifetime gift exemption ($5M per donor, indexed annually for inflation). To the extent the gift exceeds the annual gift-tax exclusion, or if the annual gift-tax exclusion does not apply, the donor is required to file a gift tax return, listing the fair market value of the property given away. In addition, supporting documentation must be provided and gift taxes paid, if required.

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If cash or securities traded on a recognized exchange are being gifted, then there is no valuation issue. If other property is being gifted, however, then valuation is important to determine if the gift would fall within one of the gift-tax exemptions, or if gift taxes will need to be paid.

To complicate matters, the value of the gift may also depend upon the nature of the asset being gifted and the strategy being used to make the gift. In addition, the gift may be deemed a partial gift, or a gift at a discounted value. For example:

A. The donor wishes to make a deferred gift by creating a Grantor Retained Annuity Trust (GRAT). In this strategy, assets are gifted into a trust but the grantor retains an income interest for a certain period of time. At the end of the period, the remaining assets in the trust are transferred to the trust beneficiaries. The value of the gift in a GRAT equals the value of the asset transferred into the trust less the present value of the income interest. The gift value would be deemed a taxable gift, and unless it (together with all previous taxable gifts) can be covered by the lifetime gift exemption, a tax will be due.

B. The donor may wish to give away a minority interest in a business. For example, John wants to gift 30% of his business to Cindy. Is Cindy's 30% share really worth 30% of the value of the entire business? She can't control the business so long as John is the majority owner. John and Cindy, wishing to keep this as a family business, may also have an agreement that restricts their ability to freely transfer their ownership interest to others. Usually, a minority interest can be discounted because of lack of control. If there is an agreement to restrict the transfer of the ownership interest, there may also be a discount for lack of marketability. Determining that discount, however, is complicated. The amount of the discount should be determined by a qualified appraiser. Note that valuation discounts are frequently contested by the IRS.

C. It may be difficult to give away a partial interest in certain types of property, such as real estate. However, it is common practice to transfer property into a business entity, such as a limited liability company or family limited partnership to own the property. LLC membership interests or FLP partnership interests can then be given away or sold. What is the value of the fractional interest? Again, determining that amount can be difficult and should be determined only by a qualified appraiser.

Note, that those who are considering gifting or selling property to close relatives or to a trust should take advantage of recent economic conditions that have depressed values, resulting in lower gift tax consequences. It should also be noted that certain proposals in Congress, if enacted into law, would further reduce or eliminate the amount of discount in certain family transactions.

3. Estate Equalization. A common estate plan is to equitably divide an estate among beneficiaries. For example, one beneficiary may be interested in taking over the family business, while another would prefer to have other assets, such as cash or cash equivalents. Still another beneficiary may desire jewelry or other property with financial as well as emotional value. To provide an equitable division of assets, the fair market value of each asset needs to be ascertained. It may be unfair for one child to inherit an asset, such as the family business, leaving other assets to the other child because the business may make up the bulk of the value of the estate.

4. The Business as the Retirement Pan. A business owner may view his/her business as his/her "retirement plan". The plan is to sell the business at retirement and live off the after-tax proceeds from the sale. Unfortunately, the business may not be worth as much as s/he thinks, or in some cases worth more. If the business was overvalued, the business owner may not realize enough from the proceeds for a comfortable

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retirement and may need to delay retirement or reduce his/her retirement life style.

It makes financial sense for a business owner to consider one or all of the following:

A. Ascertain the fair market value of the business from a qualified business valuation company. This objective value for the business will help the owner determine the appropriate sales price for the business.

B. Enter into a business succession plan with a co-owner of the business or a key employee. This is an agreement where one party is obligated to purchase the business at the retirement, death or disability of the owner, at a predetermined price.

C. Create capital outside the business to supplement retirement. Common strategies include fully funding qualified retirement plans, and purchasing cash value life insurance and deferred annuities.

5. Establishing a Buy-Sell Agreement. A buy-sell agreement is a contract where the business, co-owner, key employee or third party is obligated to purchase (and the owner or owner's estate is obligated to sell) a business owner's interest, usually at retirement, death, disability or other event. A key component of the buy-sell agreement is the value of each owner's interest in the company. A selling owner (or his estate) wants to realize a fair and reasonable price for the business interest, and the purchasing party does not want to overpay. By having a proper valuation of the business and methodology to update and maintain that valuation, all of the parties can rest assured that they will be treated equitably in the transaction. To make sure the purchasing party has the funds to pay the purchase price, the plan should be informally funded with products such as cash value life insurance and disability buyout insurance.

6. Gift or Transfer of a Life Insurance Policy. There are a number of reasons to transfer a life insurance policy. For instance:

a. The owner/insured of a life insurance policy may want to transfer an existing policy to an irrevocable trust so that the death benefit will not be subject to estate taxes at death.

b. A business may own a policy and wishes to transfer the contract to the insured/employee when s/he retires.

c. A qualified pension or profit sharing plan may be partially funded with life insurance that will be distributed to the insured/plan participant at retirement.

In each case the policy's fair market value needs to be ascertained to determine the appropriate gift tax or income tax. The value of the policy is generally based on the type of policy involved.

The value of a whole life policy which has been in force for some time typically equals the interpolated terminal reserve and unearned premium plus a pro rata portion of expected dividends to be paid as of the date of transfer. Universal life insurance policies are valued differently. The value generally equals the PERC amount. PERC is an abbreviation for premiums, earnings, reasonable charges multiplied by the "average surrender factor" which is typically one for most situations involving a policy transfer. Annual renewable term insurance is generally valued as the amount of unearned premium for the year. A newly-purchased policy is generally valued at the premium paid. These methods were defined in guidance received from the IRS.

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For more modern types of insurance policy designs, such as level premium term insurance, indexed universal life, secondary guarantee universal life, no-lapse guaranteed universal life, variable universal life, and others, there are no definitive methods to determine fair market value of the policy. For those types of policies, you may need to obtain a professional valuation of the policy. Issuing insurance companies may provide valuations as a courtesy to the policy owner, but these values may not necessarily represent the actual fair market value of the policy due to variations in the way these modern policies are valued. Note also, that the fair market value of a policy will usually be different than the cash value or the surrender value of the policy.

Note also, that for charitable giving purposes, the value of a life insurance policy gifted to a charity is limited to the lesser of the donor's cost basis in the policy or the fair market value of the policy.

7. Divorce. An asset owner (e.g., a business) who is contemplating divorce should know the value of his/her assets. Obviously, the asset owner and the spouse have conflicting goals. The asset owner would generally want a low valuation, while the spouse would want a higher valuation. Regardless of each spouse's position, it may be best to ascertain value to avoid protracted litigation and the costs of forensic accounting.

8. Charitable Planning. Donors who make outright gifts of non-cash property worth more than $500 need to substantiate the value of the property by a qualified appraisal. This requirement is in addition to the rule that donors must obtain written acknowledgement from the donee of any gift, whether cash or non-cash, which exceeds $250 in value. Similarly, donors who gift property via charitable vehicles, such as a charitable trust or pooled income fund must also have proper valuations in order to determine the value of any charitable deduction.

9. ESOP Valuation. Employee stock ownership plans (ESOPs) are qualified retirement plans set up by corporations that invest primarily in the company's stock. These corporations could be publicly traded or privately held companies. Privately held corporate stock, however, has unique challenges with respect to determining the value of the corporate shares. While this valuation issue is not under the control of the individual participants of the plan, it is still important to understand the reasons why valuation is critical because many are employees of privately owned corporations and may have an ESOP as part of their retirement plan. For business owners, valuation is obviously important because it impacts contribution levels to the plan.

As a result of the difficulty in valuing private corporations, the law requires that the company have an independent valuation performed of the value of the stock held in the plan each year. This requirement is to protect the plan participants and to ensure that the ESOP does not pay more than "adequate consideration" for the shares of the corporation. This, of course, helps to protect the value of an employee's retirement account. Note that valuation of an ESOP can be even more complicated than the valuation of a business

10. Business Financing. Business valuation is critical for a business owner who is seeking financing from a lender or who is looking for investors. While a bank or investor may look at many factors in order to enter into a transaction with the business and the business owner, such as cash flow, management, the type and nature of the business, and general economic indicators for the particular business and industry, the business owner must know the objective value of his business in order to obtain the best loan terms or to properly price any investment offering.

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As you can see, for many individuals and business owners, understanding valuation can help to protect their families, their business and themselves from unforeseen taxes and financial problems. We have described 10 common situations where proper valuation would be critical. There may be other situations as well.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

Lanny D. Levin, CLU, ChFC
LANNY D. LEVIN AGENCY, Inc.
1751 Lake Cook Road suite 350
Deerfield, IL 60015
(847) 597-2444
lanny_levin@levinagency.com

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