

Valuation Adjustments Provide Opportunity for Planners

Valuation adjustments, often referred to as “discounts,” should be on the strategy list of every comprehensive planner. They can provide amazing tax efficiencies for clients, offer opportunities to collaborate with other professionals, and allow the planner to bring an advanced planning technique to high-net-worth clients and prospects.

Traditional securities, such as stocks, bonds, and mutual funds, are easily valued due to the liquid nature of their markets. Valuing other, non-traded assets is a little more difficult. What is the current fair market value (FMV) of your client’s real estate holdings? What is the current FMV of the partnership interest he owns with his golf club buddies that invested in a private placement startup company? What is the FMV of your client’s personal business?

The FMV of these assets is important for a number of reasons. For starters, it directly affects your client’s net worth statement. It also affects his total estate value and the gift tax value when these assets are transferred to other family members and/or charity. Furthermore, it affects business transition and succession planning, including the possible sale of a family-run business. And it could affect a client’s liquid securities portfolio allocation. However, it’s likely that very few clients, much less their advisors, know the FMV of these assets or even a close approximation thereof.

Why not? Much of it has to do with an unspoken cost/benefit analysis. If a client isn’t considering the sale of a particular illiquid asset such as an apartment building, then knowing that

asset’s current FMV might not seem important and thus not worth the expense of an appraisal. The same thinking applies to a personal business. Does it really matter if the business is worth \$8 million or \$10 million today, assuming there’s no pending sale or transfer activity? Maybe it does—because how does one plan for the long-term financial security of a client without knowing the value of all the assets at his disposal?

Determining Fair Market Value

Most advisors are familiar with FMV, but let’s review, just in case. FMV is an estimate of the price for which a property (physical property, family-owned business, etc.) would sell under normal market conditions. The FMV of an illiquid asset must be determined by a qualified appraisal as defined in the tax code.

Importantly, when an illiquid property is held by multiple owners, the appraiser will likely report a FMV that is less than the net asset value (NAV) or book value of that property. The three most common principles that give rise to a valuation adjustment or discount are: 1) lack of marketability, 2) lack of control (minority interest), and 3) lack of liquidity. There are other factors that apply in various circumstances, but these are the most common and universal.

For example, imagine that Bill owns 25 percent of a small manufacturing firm. The other 75 percent is owned in equal parts by three of Bill’s college buddies. They started the company together in their senior year and have been in business for 15 years. The company is profitable and growing. Bill decides to cash out and

move to the mountains to become a ski bum, and he wants to sell his minority stake. On paper, the book value of the company is \$10 million, meaning that Bill’s stake is theoretically worth \$2.5 million. But can he actually sell his share for \$2.5 million?

The three partners don’t want Bill to leave the company, and they don’t currently have the means to buy him out. So Bill must find a buyer for his interest. After several months of putting out feelers, he finds an interested party. However, the prospective buyer will not meet Bill’s asking price of \$2.5 million and instead demands a FMV analysis.

The qualified appraiser reviews the company in great detail, including the history of the firm, the projections for the future, and any contractual obligations between the partners that may be defined in the partnership agreement, operating agreement, or other documents. The appraiser takes into account that the new buyer will be purchasing a minority interest in the company and will not be able to out-vote the three close college friends who have been in business together for 15 years. The new buyer will not easily be able to convert his ownership to cash should he decide to sell at a later date. Thus the appraiser’s FMV report comes back reflecting a 50-percent valuation adjustment (or discount) and quotes the current FMV of Bill’s 25-percent stake as \$1.25 million.

This is usually where negotiations between Bill and the potential buyer will begin. Bill will argue for higher than the \$1.25-million appraisal due to a variety of factors such as future cash flows, business

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opportunities, growth forecasts, and so on. Whatever number they agree on will be the true FMV of Bill's interest. The appraisal was the best estimate without any actual sales transactions to compare.

Using FMV Analysis

Knowing that illiquid assets may be subject to substantial discounted valuations, planners can assist clients in a variety of wealth-transfer situations to reduce the tax impact that would otherwise apply. For example, if Bill was not selling his interest but rather transferring it to several trusts for his children's benefit, the federal gift tax would normally apply. In the example above, Bill could use the \$1.25-million figure for reporting the value of the gifts, rather than the \$2.5-million book value.

The most common application of valuation adjustment principles is through

a family limited partnership (FLP) or a family limited liability company (FLLC). These entities are regular LPs or LLCs, except that they are owned entirely within a particular family (i.e., no outside non-family partners or members). The common scenario has the senior-generation family members who are the source of wealth creation establish the FLP/FLLC and transfer various assets into it. Typical holdings include real estate, family businesses, other partnership interests, and securities portfolios. The senior generation then transfers minority interests in the FLP/FLLC via gift or sale to various children, trusts, and/or charities. Prior to the transfer, they retain a qualified appraiser to perform an analysis and determine the FMV of the minority interests to be transferred.

The same valuation adjustment principles described above apply to these

interests. Lack of marketability, lack of control (minority interest), and lack of liquidity all factor in to the FMV report for the FLP/FLLC interests. Adjustments or discounts in the range of 25 percent to 50 percent are common on these assets.

FLPs/FLLCs can be combined with numerous other wealth-transfer techniques to maximize the benefit from the valuation adjustment. For example, a client might transfer discounted assets to a charitable lead trust (CLT) that has been "zeroed out" for gift tax purposes—meaning that no taxable gift is made upon funding the trust. The client's children or trusts for their benefit might be the final principal beneficiary of the CLT. Any amount above the discounted FMV will ultimately pass tax-free to the heirs. Discounted assets can be used to fund grantor-retained annuity trusts (GRATs) in the same fashion.

Another common scenario involves the sale of discounted assets to intentionally defective grantor trusts (IDGTs). As a grantor trust, the tax consequences of activity in the trust flow back to the grantor. So the sale of assets from the grantor to the trust does not result in a taxable event, nor does interest paid on a note from the sale generate taxable income since the grantor is selling an asset to himself for tax purposes. The IDGT will typically have the grantor's children as beneficiaries. Instead of gifting assets to the trust and incurring gift tax or using up the grantor's lifetime gift tax exemption, the grantor will sell minority interests in the FLP/FLLC to the IDGT in exchange for a promissory note payable over a term of years. The sale price is the FMV as determined by the appraisal, rather than NAV or book value of the FLP/FLLC interest.

For example, assume a 10-percent FLP/FLLC interest with a book value of \$1 million. The FMV as determined by qualified appraisal reflects a 40-percent adjustment down to \$600,000. The client will sell the FLP/FLLC interest to the IDGT in exchange for a promissory note of \$600,000. The additional \$400,000 of

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Private Investment Funds

Planners and clients also can use private investment fund structures to

achieve the same types of discounts. Private investment funds apply the same valuation-adjustment principles found in FLPs/FLLCs, but avoid the hassle of forming, funding, and managing a FLP/FLLC. The administration and qualified

appraisal process are handled at the fund level, which saves the client and the advisors time and money. In addition, these funds are typically IRA-compliant, which means clients can get discounted valuation advantages on Roth conversions and other IRA distributions, thus reducing the tax impact of those transactions.

The devil is always in the details, so advisors must ensure that they work with attorneys and CPAs who understand this area in depth. Handling the transactions properly is important because the IRS, for obvious reasons, is not a fan of valuation adjustments and loves to challenge them when possible.

Assuming the proper steps are taken in establishing and operating the FLP/FLLC, review by the IRS often comes down to an argument over the FMV. In many cases, this results in a judge trying to decide between the taxpayer's valuation expert and the IRS's appraiser. As might be expected, judges often find the actual FMV to be somewhere in the middle between the two experts' numbers.

Given the uncertainties about what Congress will do with the estate tax, this may be the best time to implement valuation adjustment strategies with high-net-worth clients. Proposals are floating around that would limit or disallow discounts in various circumstances. Moving ahead will enable advisors to implement these strategies ahead of any potential changes down the road. **NA**

Joe Luby is founder and manager of Jagen™ Investments, LLC, headquartered in Henderson, NV. Jagen Investments has created funds that are designed as a series of specialty limited liability companies (LLCs) that allow likeminded individual investors to pool their assets and invest at the institutional level using portfolios, investments, and managers they could not typically access on their own. Luby may be reached at 702-451-3456 or jluby@jagenfunds.com; the firm can be visited online at www.jagenfunds.com.

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	Inception Date	Since Inception	10 year	5 year	3 year	1 year
Perkins Discovery Fund	04/09/98	11.73%	2.26%	5.84%	-4.90%	80.41%
DJ Wilshire U.S. Micro-Cap Index		7.12%	5.03%	0.99%	-6.56%	83.11%
Russell 2000 Index		4.28%	3.68%	3.36%	-3.99%	62.76%
NASDAQ Composite Index		2.33%	-6.25%	3.70%	-0.33%	56.87%
S&P 500 Index		2.20%	-0.65%	1.92%	-4.17%	49.77%

Gross Expense Ratio - 2.95% Net Expense Ratio - 2.03%¹

Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-800-998-3190. The fund imposes a 1.00% redemption fee on shares held less than 90 days. Performance data quoted does not reflect the redemption fee. If reflected, total returns would be reduced. Investment performance for the fund reflects fee waivers in effect. In the absence of such waivers, total return would be reduced.

¹ The adviser has contractually agreed to cap expenses to 2.00% indefinitely.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling (800)366-8361, or visiting www.perkinscap.com. Read it carefully before investing.

Small-capitalization companies tend to have limited liquidity and greater price volatility than large-capitalization companies. The fund invests in micro-cap and early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies. As a result, investors considering an investment in the Fund should consider their ability to withstand the volatility of the Fund's net asset value associated with the risks of the portfolio.

The Dow Jones Wilshire U.S. Micro-Cap Index is formed by taking the 2,500 smallest companies, as measured by market capitalization, of the Dow Jones Wilshire 5000 Index. The Russell 2000 Index is composed of the 2,000 smallest companies in the Russell 3000 Index, and is widely regarded in the industry as the premier measure of small-cap stocks. The S&P 500 Index is a broad based unmanaged index of 500 stocks widely recognized as representative of the equity market. The NASDAQ Composite Index is a broad-based capitalization-weighted index of all NASDAQ national market and small-cap stocks. One cannot invest directly in an index.

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