Valuation

What is valuation?

Valuation is any method used to assign a dollar value on property or business interests for federal gift and estate tax and federal generation-skipping transfer (GST) tax (together referred to here as estate taxes) purposes. Knowing the value of your property may help you estimate and plan to reduce any taxes that may be owed.

Valuation can be a complex and highly speculative process. The IRS may challenge the value you place on a particular item. To prevent a dispute with the IRS and to keep the court from becoming involved in a valuation question, you and your personal representative should use care and thoroughness in arriving at a reasonable value. Use published references (newspapers or valuation tables issued by the IRS) when possible. Refer to IRS regulations and rulings concerning how property is to be valued for tax purposes. You and your personal representative may need or want to use one or more qualified experts and appraisers for certain property and to create documentation to back up the values you establish, especially for hard-to-value assets (e.g., real estate and stock in closely held companies).

> **Tip:** An expert appraiser can be found through the yellow pages or by seeking referrals from banks, financial planners, attorneys, or real estate brokers. Be sure to check the appraiser's credentials for experience in valuing property for estate tax purposes.

> **Tip:** Formal appraisals are generally not required to be attached to tax returns except when real property has been valued using the special use valuation method, or when assets are considered "hard to value."

How do you value property included in an estate for estate tax purposes?

The general rule is that the value of an estate for estate tax purposes is the fair market value (FMV) on the valuation date, but other valuation methods may apply.

Fair market value (FMV)

FMV means the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts. In other words, it's what property would sell for on the open market. In the absence of an actual sale, the value must be based on a hypothetical sale. This can be difficult where there is no established market for identical property. Many factors must then be considered, such as the comparable worth of similar property, the comparable worth in a similar market, and how much the potential benefits are worth.

> **Tip:** It may be helpful to consult an appraiser for an estimate of value on items such as jewelry, art objects, collectibles, antiques, and real estate.

> **Caution:** The FMV of real estate is not its assessed value for property tax purposes.

Special use value

Under certain conditions, your personal representative may elect to value real property used for farming, for a family-owned business, and for certain woodlands based upon its actual use, as opposed to its FMV under the "willing buyer, willing seller" test. This special valuation, however, cannot reduce your gross taxable estate by more than a certain amount ($1,040,000 for estates of persons who die in 2012).

> **Tip:** The ceiling of special use valuation is indexed annually for inflation. The cost-of-living adjustment is the percentage, if any, by which the Consumer Price Index (CPI) for the preceding year exceeds the CPI for the calendar year 1997. Indexing is rounded to the next lowest multiple of $10,000.

To qualify for the special use valuation:

- You must be a U.S. citizen or resident at the time of your death
- Your personal representative must make an election on your estate tax return
- Your personal representative must sign a recapture agreement form and attach it to your estate tax return
- All of the following requirements must be satisfied:The property must be qualified real property. It must be located in the United States and be used as a farm or by a closely held business on the date of your death. There are also special percentage, usage, and designation requirements that must be satisfied.
- At least 50 percent of the adjusted value of your gross estate must consist of the value of real and personal property used in the trade or business.
- At least 25 percent of the adjusted value of your gross estate must be the adjusted value of the farmland or closely held real property.
- The property must pass to a qualified heir. A qualified heir is a family member. Family members include your spouse, your ancestors, your lineal descendants, your parent's descendants, your spouse's descendants, the spouse of your lineal descendants, and the spouse of a lineal descendant of your parent or spouse.
- The real property must have been owned and used for a qualified use by the decedent or a member of the decedent's family for a period aggregating five years or more during the eight-year period ending on the date of death.
- You or a family member must have materially participated in the operation of the farm or closely held business for an aggregate of five years or more of the eight-year period ending on the earlier of the date of your retirement, disability, or death (assuming that your retirement or disability continues until your death).

The value of farm property is commonly determined using the capitalization of rents method, but may also be valued using the five-factor method. Real property held by a closely held business must be valued using the five-year method. Under this method, the value is determined by evaluating the following factors:

- The fair rental value of the property for farmland or closely held business purposes (capitalized)
- Assessed property values (in a state that provides a differential or use value assessment law with respect to farmland or closely held business purposes)
- Income or yield that can be expected over a given period of time from the property being used as farmland or in a closely held business
- Comparable sales of property in the same area
- Any other factor that fairly values farm or closely held business value of the property

Caution: Due to the complexity of the special use rules, you should arrange your estate as early as possible to qualify. The IRS may pay close attention if the special use valuation is elected.

Caution: The IRS will recalculate (recapture) the estate tax due if, within the 10 years following your death, the property in question is disposed of or ceases to be used for the originally qualified use. Special use valuation should be elected only if your real property is expected to remain in the family farm or business.

Other valuation

The IRS has issued regulations providing detailed instructions for the valuation of particular types of property. Some of these types of valuations are complex, especially life insurance, corporate bonds, closely held business interests, and professional practices. You should consider seeking expert advice if you own these types of property. The following is a brief discussion of some of these types of valuations:

- Valuation of annuities, life estates, remainders, income interests, and reversions is determined using actuarial tables issued by the IRS

- Most U.S. government bonds are valued at their FMV as of the date of your death, which is generally the lower of the redemption price and the par value

- Certain U.S. Treasury bonds (flower bonds) may be redeemed at par value (plus accrued interest) if they are used to pay estate taxes; otherwise, they are valued at the mean quoted selling price on the valuation date or par value, whichever is higher

- Life insurance proceeds payable to or for the benefit of your estate are valued at the amount receivable, including dividends, premium refunds, and lump-sum settlements

- An unmatured life insurance policy owned by you on the life of another is included in your gross estate. The value of the policy is generally determined by using the sale price of comparable policies by the insurance company. If this value is not reasonably ascertainable, the policy may be valued by adding the interpolated terminal reserve value at the date of death to the proportionate part of the premium last paid that extends beyond the date of your death. A similar method is used for valuing unmatured policies transferred as gifts.

- Stocks that are traded on a major exchange or over the counter have their value determined by averaging the high and low selling prices on the date of death. The closing price is not used. If a stock's price fluctuated between $6 and $8 on the date of death, the average of $7 per share is used for determining the value of the stock. If the death occurred on a weekend or holiday when the market is closed, the high and low values for the trading date prior to the death and those of the next trading date are re-averaged. Stocks that are traded ex-dividend must also include in their valuation the amount of any dividends even though that payment will occur in the future. Stocks considered ex-dividend are those for which a dividend has been declared for the shareholders of record, but have not yet been paid.

- Valuation of corporate bonds mirrors the method used for listed stocks. In the absence of an established market, the value is determined by evaluating the following factors:The soundness of the security

- The date of maturity

- The extent to which the bond is secured

- The interest yield as compared to similar bonds

- The listed prices of similar bonds

- All other relevant factors

- Valuation of a closely held business is very difficult. Although many factors should be evaluated, the following three approaches are among the more common: The market approach, in which the selling price of a comparable company, the book value of the company, and the going concern value may be considered.

- The income approach, in which the capitalization of the income stream would be considered.

- The cost approach, in which the replacement cost would be considered. This third approach is seldom used for valuing a closely held business.

In addition, the valuation of a closely held business may involve applying premiums or discounts. It may be appropriate to consider the following: minority interest discount, swing vote premium, control premium, key person discount, and lack of marketability discount.

> **Caution:** The IRS is wary of and places special emphasis on entities that are structured in a way that maximizes discounts.

> **Tip:** Because valuing a closely held business is complex and because the IRS is on the lookout for this

type of valuation, you should consult at least one professional appraiser, and may consider getting several opinions.

- Valuing a professional practice is probably the most complex type of valuation process. There are many different factors that are difficult to quantify and the method used may depend upon the purpose of the valuation. You should encourage your personal representative to consult someone with particular expertise in this area.

Date of death valuation

The valuation date is generally the date of death. A date of death is established by the date in your place of domicile (where you live), and a date of death value is determined at the instant or moment of death.

Example(s): Sally is a U.S. citizen and resident of Boston. Sally dies while vacationing in Greece on August 16 at 2 A.M., Greek time, which is August 15 in Boston. Sally's date of death is August 15, the date of her death in her domicile, Boston.

Alternate valuation date

Your personal representative may elect to use an alternate valuation date, if it results in reducing both your gross estate and the sum of any gift and estate tax plus any generation-skipping transfer (GST) tax that is due. If this method is elected, all your property is valued either as of the date on which the property is disposed of or six months after death, whichever occurs first.

Tip: This may be advantageous in the event the property included in your gross taxable estate decreases in value during the six-month period after your death. Your personal representative can postpone the election of valuation dates up until the date your estate tax return is due (nine months after death unless an extension is received). This gives your personal representative the opportunity to determine which date will be more advantageous.

Tip: If the alternate valuation date is elected for estate tax purposes, it must also be elected for GST tax purposes.

Caution: If choosing the alternate valuation date decreases the value of property included in the gross estate that passes to your spouse or to a charity, the corresponding value of the unlimited marital deduction or charitable deduction must also decrease.

Caution: Assets such as rights to patents, annuities, life estates, reversions, and remainders change in value at least partly due to the passage of time. To the extent that lapse of time is the only reason for a change in value from the date of death to six months later, the property's date of death value must be used.

Caution: The alternate valuation date may not be beneficial because of its effect on the income tax basis (basis will be stepped-down from the value on the date of death to the value on the alternate valuation date) of property received from the estate.

How do you put a value on gifts?

Fair market value

Valuation of taxable gifts parallels the valuation of the gross estate in most respects, except: (1) the valuation date is the date on which the gift is complete, (2) there is no alternate valuation date allowed, and (3) the special use valuation method is not available.

Encumbered property

The value of a gift of encumbered property depends in part upon whether the debt to which the property is subject is nonrecourse debt or recourse debt. A debt is nonrecourse if the only security for the debt is the property purchased with the loaned funds. A debt is recourse if the creditor may seek to satisfy the debt from other sources, such as from the debtor personally. Generally, the value of property encumbered by a nonrecourse debt is the net value of the property (FMV) of the property less the amount of the obligation). If the donor of the property continues to make payments on a debt for which he is no longer liable, each payment is an additional gift. If the debt is recourse and the donee (the person you give to) has the right to recover the debt from you, the value of the initial gift may be the FMV, unreduced by the amount of the debt.

> **Example(s):** Michael transfers a $100,000 building subject to a $40,000 nonrecourse debt to his son Shaun. Because the debt is nonrecourse, and may only be satisfied out of the transferred property, the value of the gift is the FMV less the debt, or $60,000.

> **Example(s):** If Michael had instead transferred a $100,000 building subject to a $40,000 recourse debt on which Michael remained personally liable, and Shaun had the right to compel Michael to pay the debt, the value of the gift would be the full $100,000 FMV.

Interest-free or below-market loans

Giving a loan interest free or below the market rate is a taxable gift. The value is determined by computing the forgone interest. The forgone interest is the difference between the interest computed using the applicable federal rate and the interest computed using the stated rate. How the value of the forgone interest is determined depends upon whether the loan is a term loan (when interest is payable at a rate less than the federal rate) or a demand loan (when the amount loaned exceeds the present value of all payments due under the loan).

Gifts to charity

Some gifts to charity may be valued at less than FMV depending on the type of gift and the type of charity. Practically, however, this does not matter for estate tax purposes because the value assigned to such gifts is also deductible under the charitable deduction.

These are the views of Forefield Inc., not the named Representative nor Broker/Dealer, and should not be construed as investment advice. Neither the named Representative nor Broker/Dealer gives tax or legal advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The publisher is not engaged in rendering legal, accounting or other professional services. If other expert assistance is needed, the reader is advised to engage the services of a competent professional. Please consult your Financial Professional for further information. Securities offered through Questar Capital Corporation, Member FINRA/SIPC and/or Advisory Services offered through Questar Asset Management (QAM) A Registered Investment Advisor.

A G M Investment Group, Inc.
Comprehensive Financial & Life Planning
Joe Gallego
NAPERVILLE, IL 60540
Office 630-857-9177
Cell 630-362-5117
joe@agmig.com
www.agmig.com

Prepared by Broadridge Investor Communication Solutions, Inc. Copyright 2012