HodgsonRuss LLP ATTORNEYS

# Estate Planning for Real Estate Using Valuation Discounts

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New York State Bar Association
Trusts and Estates Law Section
2015 Fall Meeting

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## I. Date of Valuation

a) For lifetime transfers, the gift is valued as of the date of the gift. IRC § 2512.

b) For estate tax purposes, property included in the gross estate is valued as of the decedent's date of death. IRC § 2031(a).

   i) However, the Executor may elect to use the alternate valuation date, which is six months after the decedent's date of death. IRC § 2032. The election must be made for the entire estate, and cannot be made on an asset by asset basis. The election must decrease the value of the gross estate, and the estate tax due.

## II. Willing Buyer / Willing Seller

a) Property must be valued at its fair market value.

b) Willing buyer / willing seller test:

   i) "The fair market value is 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 to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(a); *see also* Treas. Reg. § 25.2512-1 (stating the willing buyer / willing seller test in the gift tax context).

c) Who are the Willing Buyer and Willing Seller?

i) They are hypothetical individuals, not actual individuals. *See Estate of Elkins, Jr. v. Commissioner*, 767 F.3d 443, (5th Cir. 2014); *Estate of Newhouse v. Commissioner*, 94 T.C. 193 (1990); *Estate of Bright v. United States*, 658 F.2d 999 (Former 5th Cir. 1981).

(1) Consider if estate owns a 50% tenant in common interest in a house, and surviving wife owns the other 50%. How much would a hypothetical buyer pay to purchase the estate's 50%? The hypothetical buyer would demand a decrease in the price; if he only owns 50%, he will not have control and he will have a difficult time reselling his 50% to the general public. If the relevant standard were how much would the likely buyer pay, the appraiser would have to take into account the wife, who likely would be willing to buy the 50% interest at a premium in order to gain control of her house.

## III. Attribution and Aggregation

a) Gift tax versus estate tax

i) For gift tax, the interest being valued is the interest being gifted. For estate tax, it is the decedent's entire holding.

(1) Consider:

(a) Example 1 (gift tax): Mom owns 60% of Real Estate Holdco LLC. She gives her son a 30% interest, and she gives her daughter a 30% interest. The interest being valued for each gift is a 30% minority interest, and discounts may be available.

(b) Example 2 (estate tax): Mom owns 60% of Real Estate Holdco LLC. Her Will directs that 30% be distributed to son, and 30% be distributed to her daughter. At her death, the interest being valued is the entire 60%, which will likely be subject to a control premium. It does not matter that the bequests are of two minority interests; the interest being valued is the entire 60% interest that mom owned at her death.

(c) In some situations, it may make sense for mom to give away her 60% interest during life by making a series of minority interest gifts. Holding the 60% in her estate may lead to premiums and an increased transfer tax value.

b) Generally, there is no family attribution

i) The interest being valued is the interest that was gifted by the transferee, or the interest owned by the decedent at death. The interest is not aggregated with what other family members or friends own. *See Estate of Bright v. United States*, 658 F.2d 999 (Former 5th Cir. 1981).

(1) Example: Mom owns 40% of Real Estate Holdco LLC. She gives her son a 30% interest. Son already owns 35%, meaning that after the gift he will own 65% and have control. The interest being valued is the 30% minority interest given from mom, and discounts may be available. It does not matter that both before and after the gift, mom and son collectively have control. There is no family attribution.

ii) But, if the Chapter 14 valuation rules are implicated, family attribution does come into play.

c) There is no aggregation of interests owned by decedent and a QTIP trust.

i) If decedent owns a partial interest in real property, that interest is included in the decedent's gross estate under IRC § 2033. If the decedent was a beneficiary of a qualified terminable interest property trust (a "QTIP trust"), and the QTIP trust also owns a partial interest in real property, that partial interest is included in the decedent's gross estate under IRC § 2044. However, the two interests are not aggregated for valuation purposes. *See Estate of Bonner v. United States, 84 F3d 196* (5th Cir. 1996).

(1) Example: Decedent owned 30% of Real Estate Holdco LLC. She was also a beneficiary of a QTIP trust that owned 40% of Real Estate Holdco LLC. Both interests are subject to estate tax at her death, but they are valued as two separate blocks. Accordingly, when determining whether discounts are available, her estate is treated as owning two minority interests instead of one 70% controlling interest.

(2) On the first death, consider dividing the Real Estate Holdco LLC interest between QTIP trust, surviving spouse individually, and/or credit shelter trust so that on wife's later death a controlling block of Real Estate Holdco LLC is not included in her estate.

## IV. Highest and Best Use

a) Property must be valued at its highest and best use, not its current use. *Arbor Towers Associates, Ltd. v. Commissioner*, T.C. Memo 1999-213.

i) For instance, if a beloved family vacation property would be worth more if it were paved and turned into a strip mall, the property must be valued at the higher, commercial value.

ii) However, current zoning restrictions must be taken into consideration. *See Estate of Pattison v. Commissioner*, T.C. Memo 1990-428.

b) Exception for certain farms and other businesses

i) Executor may elect to use IRC § 2032A, which permits certain property (such as family farms) to be valued at its current use as opposed to its highest and best use.

c) Assemblage

i) If various contiguous parcels are owned by different individuals or entities, and if those properties may be worth more if they were assembled into one parcel, the possibility of assemblage may be considered in the valuation. For instance, a landlocked parcel may be worth more if it is assembled with the adjoining parcel that has road access.

(1) *Estate of John A. Pulling, Sr., v. Commissioner*, TC Memo 2015-134:

(a) "We can value property on the basis of a use of land requiring assemblage if it is reasonably likely that the land will be assembled in the reasonably near future. . . . This is a question of fact that can be resolved only by weighing all of the evidence."

(b) The fact that the properties may be worth more if assembled is not controlling; it must be reasonably likely that the assemblage will actually occur.

(c) In addition, the fact that the owners of the adjoining parcels are related is not controlling. There may be many reasons that they do not want to assemble the parcels, even if it would be economically beneficial for them to do so.

## V. Chapter 14 of the Internal Revenue Code – Special Valuation Rules

a) Background

i) Chapter 14 (IRC §§ 2701- 2704) provides special valuation rules for various types of intra-family transactions. It was enacted to curb perceived abuses in the transfer tax arena.

b) IRC § 2701 – Special Valuation Rules in Case of Transfers of Certain Interests in Corporations or Partnerships

   i) Intended to curb preferred stock transactions where parent would retain preferred stock and transfer common stock to his children. All appreciation would be tied to the common stock, removing the appreciation from parent's estate.

c) IRC § 2702 – Special Valuation Rules in Case of Transfers of Interests in Trusts

   i) Example: Family member A transfers a 20% interest in Real Estate Hold Co LLC to a trust for family member B, but family member A retains the right to income from the trust for 10 years. Unless the retained interest is a "qualified interest," it is valued at zero for gift tax purposes, and family member A is treated as making a gift of the entire 20% LLC interest to family member B.

d) IRC § 2703 – Certain Rights and Restrictions Disregarded

   i) Buy-sell agreements (and other options, agreements, or rights to acquire or use property at a price that is less than FMV) are essentially disregarded in valuing property unless the buy-sell agreement is a bona-fide arrangement and is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.

e) IRC § 2704 – Treatment of Certain Lapsing Rights and Restrictions:

   i) Certain restrictions on liquidation are disregarded when valuing a family entity, increasing the value. In addition, if a voting or liquidation right lapses, the lapse may be treated as a gift if the individual holding the right that lapses and members of such individual's family hold, both before and after the lapse, control of the entity.

   ii) Proposed regulations:

      (a) IRC § 2704:

> (a) Treatment of lapsed voting or liquidation rights. . . .
>
> (b) Certain restrictions on liquidation disregarded.
> (1) In general. For purposes of this subtitle, if--
> (A) there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and
> (B) the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity,
> any applicable restriction shall be disregarded in determining the value of the transferred interest.
> (2) Applicable restriction. For purposes of this subsection, the term 'applicable restriction' means any restriction--
> (A) which effectively limits the ability of the corporation or partnership to

liquidate, and

(B) with respect to which either of the following applies:

(i) The restriction lapses, in whole or in part, after the transfer referred to in paragraph (1).

(ii) The transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction.

(3) Exceptions. The term 'applicable restriction' shall not include--

(A) any commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either, or

(B) any restriction imposed, or required to be imposed, by any Federal or State law.

**(4) Other restrictions. The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.**

(c) Definitions and special rules. . . .

iii) Treasury is rumored to be working on proposed regulations under IRC § 2704, to be issued in late 2015.

iv) There is much speculation about the contents of the regulations. What other restrictions may be disregarded? The ability of certain third parties to remove the liquidation restrictions? Restrictions on a transferee being able to become a full-fledged partner or member?

# Estate Planning for Real Estate Using Valuation Discounts

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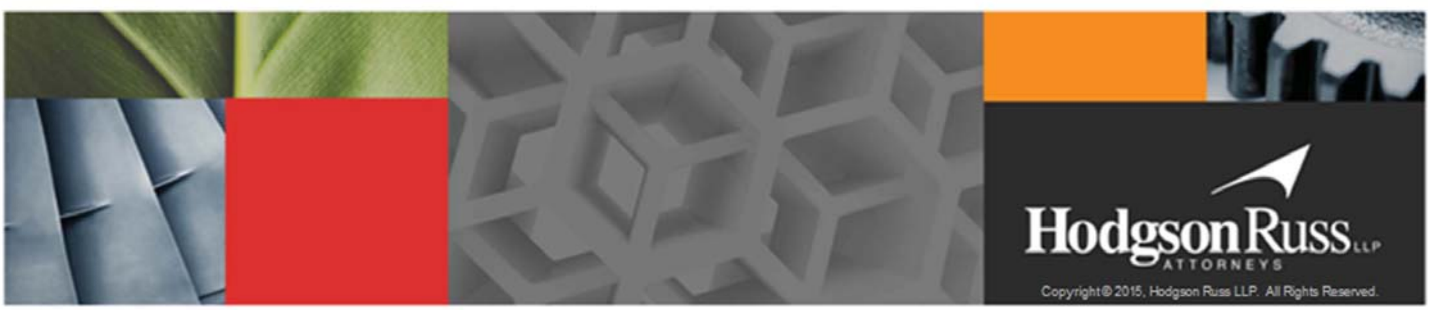


## Current estate tax exemption amounts

- 2015 federal exemption = $5,430,000
- 2015 NY exemption = $3,125,000 (but full phase out at $3,281,250)
- 2015 gift tax annual exclusion = $14k (or unlimited, if gift is between US spouses)

## Creating fractional ownership interests

- 40% of $100 ≠ $40
- Gifts or sales of fractional interests leverage the gift tax exemption and gift tax annual exclusion

## Basic Transfer Tax Valuation Rules

### Date of Valuation:

- For lifetime transfers, valuation date is the date of the gift
- For transfers at death, valuation date is the date of death (unless the IRC § 2032 alternate valuation date election is made)

## Basic IRC Valuation Rules

### The Willing Buyer / Willing Seller

- "The fair market value is 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 to sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 20.2031-1(a).

# Basic IRC Valuation Rules

## The Willing Buyer / Willing Seller

- The willing buyer and willing seller are hypothetical individuals, not actual individuals.
- Example: Estate owns a 50% tenant in common interest in a house, and surviving wife owns the other 50%.  In reality, the wife is the person who would most likely buy the estate's 50% interest, and she may very well be willing to pay a premium.  But she is not the hypothetical buyer.  The hypothetical buyer is someone dealing at arm's length, and she would likely demand a decrease in the price because, with only a 50% ownership interest, she would not have control over the house.

# Attribution and Aggregation

## For gift tax, the interest being valued is the interest being gifted. For estate tax, it is the decedent's entire holding.

- Example 1 (gift tax): Mom owns 60% of Real Estate Holdco LLC. She gives her son a 30% interest, and she gives her daughter a 30% interest. The interest being valued for each gift is a 30% minority interest, and discounts may be available.
- Example 2 (estate tax): Mom owns 60% of Real Estate Holdco LLC. Her Will directs that 30% be distributed to son, and 30% be distributed to her daughter. At her death, the interest being valued is the entire 60%, which will likely be subject to a control premium. It does not matter that the bequests are of two minority interests; the interest being valued is the entire 60% interest that mom owned at her death.

# Attribution and Aggregation

## Generally, there is no family attribution (but be aware of Chapter 14)

- The interest being valued is the interest that was gifted by the transferee, or the interest owned by the decedent at death. The interest is not aggregated with what other family members or friends own.
- Example: Mom owns 40% of Real Estate Holdco LLC. She gives her son a 30% interest. Son already owns 35%, meaning that after the gift he will own 65% and have control. The interest being valued is the 30% minority interest given from mom, and discounts may be available. It does not matter that both before and after the gift, mom and son collectively have control. There is no family attribution.

# Attribution and Aggregation

## QTIP Trusts

- If decedent owns a partial interest in real property, that interest is included in the decedent’s gross estate under IRC § 2033.  If the decedent was a beneficiary of a qualified terminable interest property trust (a “QTIP trust”), and the QTIP trust also owns a partial interest in real property, that partial interest is included in the decedent’s gross estate under IRC § 2044.  However, the two interests are not aggregated for valuation purposes.
- Example:  Decedent owned 30% of Real Estate Holdco LLC.  She was also a beneficiary of a QTIP trust that owned 40% of Real Estate Holdco LLC.  Both interests are subject to estate tax at her death, but they are valued as two separate blocks.  Accordingly, when determining whether discounts are available, her estate is treated as owning two minority interests instead of one 70% controlling interest.

# Highest and Best Use

Property must be valued at its highest and best use

- Current zoning restrictions must be taken into consideration.
- Exception for certain farms and other business:  Executor may elect to use IRC § 2032A, which permits certain property to be valued at its current use as opposed to its highest and best use.
- Assemblage: If various contiguous parcels are owned by different individuals or entities, and if those properties may be worth more if they were assembled into one parcel, the possibility of assemblage may be considered in the valuation.  For instance, a landlocked parcel may be worth more if it is assembled with the adjoining parcel that has road access.

## Highest and Best Use

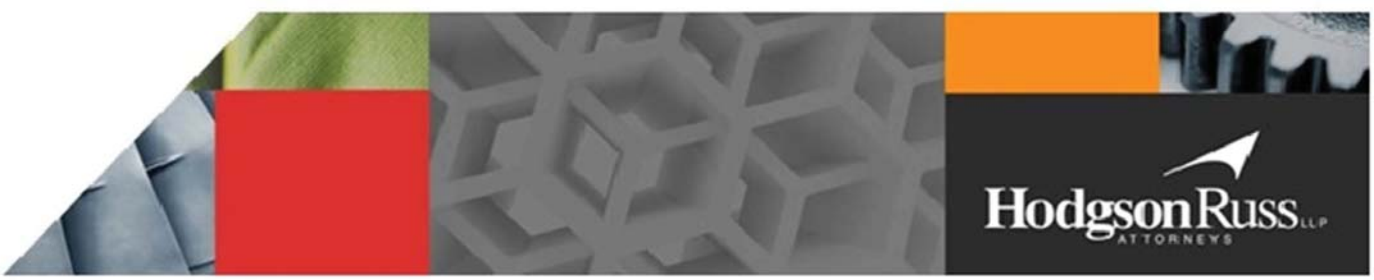
Assemblage - *Estate of John A. Pulling, Sr., v. Commissioner*, TC Memo 2015-134

- "We can value property on the basis of a use of land requiring assemblage if it is reasonably likely that the land will be assembled in the reasonably near future. . . . This is a question of fact that can be resolved only by weighing all of the evidence."
- The fact that the properties may be worth more if assembled is not controlling; it must be reasonably likely that the assemblage will actually occur.
- In addition, the fact that the owners of the adjoining parcels are related is not controlling. There may be many reasons that they do not want to assemble the parcels, even if it would be economically beneficial for them to do so.

## Chapter 14 – Special Valuation Rules

IRC § 2704 – Treatment of Certain Lapsing Rights and Restrictions

- If a voting or liquidation right lapses, the lapse may be treated as a gift if the individual holding the right that lapses and members of such individual's family hold, both before and after the lapse, control of the entity.
- Certain restrictions on liquidation are disregarded when valuing a family entity, increasing the value, if the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove the restrictions.



# Chapter 14 – Special Valuation Rules

## IRC § 2704 – Treatment of Certain Lapsing Rights and Restrictions

- IRC § 2704(b)(4): Other restrictions. The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.
- Status of Proposed Regulations

**Valuing Real Estate Holding Companies**

October 30, 2015

2015 New York State Bar Association
Trusts and Estates Law Section Fall Meeting
Presentation by:

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I. Typical Valuation Process

   A. Defining the assignment

   B. Gather Data/Research

   C. Analyze Data

   D. Arrive at a preliminary Conclusion

   E. Develop Report

   F. Internal Review/ Quality Control

   G. Deliver draft report to client for discussion

   H. Finalize

II. Defining Value

   A. Premise of Value (Going Concern versus Liquidation)

   B. Standard of Value

      1. Fair Market Value

      2. Fair Value

      3. Investment Value (specific investor)

   C. Level of Value (Control versus Minority)

1. Prerogatives of Control (set compensation, set distribution policy, make acquisitions or divestitures, sell the Company or its assets, set strategic policy, take on debt, etc.)

III. Levels of Value - Discounts and Premiums

IV. Primary Valuation Methodologies

A. Income

B. Market

C. Asset/Cost

V. Valuing a Real Estate Holding Company

A. An income approach or an asset approach may be employed
- Oftentimes a real estate appraisal is prepared for the underlying real property
- The RE Appraisal is then used as an input to the asset approach (i.e., adjusted book value method)
- With small minority interests it may be appropriate to utilize an income approach

B. A secondary method may be used as a reasonableness assessment
- Implied yield analysis relative to market benchmarks
- Implied price per square foot comparison
- Implied cap rate comparison

VI. Valuing a RE Holding Co – ABV Analysis

A. The Company's balance sheet is spread and analyzed (along with other historical financial data)

B. The Company's assets and liabilities are adjusted to market value
- Adjustments include off-balance sheet, intangible, and contingent items
- The primary adjustment is oftentimes the estimated market value of the underlying real property

C. The aggregate ABV is calculated by subtracting the market value of the liabilities from the market value of the assets

D. Consideration is given to a discount for lack of control for non-controlling interests
- Various market based benchmarks are utilized to develop a discount for lack of control

E. Consideration is given to a discount for lack of marketability to reflect the illiquidity of the underlying interest
- Qualitative and quantitative models are employed

VII. Factors Impacting Discounts

A. Timing and amount of distributions

B. Likelihood and timing of liquidation/exit events

C. Ownership rights

D. Put option rights

E. Ability to transfer or withdrawal

F. Other restrictions in the operating/partnership agreement

G. Built-in capital gains in C-corp. holding companies

VIII. Sample ABV Calculation and Application of Discounts

IX. Factors affecting the Value of an RE Holding Co

A. External Factors - factors that are beyond the control of owners / management

- interest rates
- market rates (yields, cap rates, discount rates)
- debt financing costs
- market and regional economic conditions
- location/competition
- government regulation/policies

B. Internal Factors - factors that owners / management can control or influence

- condition of books and records
- property/facility conditions
- discretionary costs
- financial leverage
- management fees/perquisites

C. Synergy

- When the union of two parts is greater than the <u>sum</u> of the two parts. The expected synergy achieved through a merger can be attributed to various factors such as increased revenue, combined talent and technology, or cost reductions
- Generally not applicable in the context of FMV

X. Other Valuation Issues

A. Partial Interests (TIC) in Real Property

- Cost to partition analysis (Ludwick case)

B. Built-in Capital Gains

- Valued as a Liability or dealt with through the application of discounts
- Several court cases discuss the issue (Jensen; Jameson; Eisenberg; and Davis cases)
- Treatment may vary depending on the methodology employed and court jurisdiction

C. S-corp./Pass-through Entity Adjustment

- Relevant when valuing minority interests
- Applicable when using an income approach
- May not be applicable when using an Asset Approach, if similar types of pass through entities are used for benchmarking

XI. Basic Valuation Concepts

A. Adjusted Book Value Method - A method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent) are adjusted to their fair market values

B. Total Invested Capital – the sum of all classes of equity and debt in a business enterprise

C. Capital structure – the composition of the invested capital of a business enterprise, the mix of debt and equity

D. Discount Rate – a rate of return used to convert a future monetary sum into present value

E. Weighted average cost of capital (WACC) – the discount rate determined by taking a weighted average of the cost of all financing sources (i.e., debt and equity) in the business enterprise's capital structure

F. Capitalization Rate – any divisor used to convert anticipated future economic benefits of a single period into present value. The discount rate minus the long term growth rate is equal to the cap rate

G. Multiple – the inverse of a capitalization rate. Market multiples represent the market value of a company's stock or total invested capital divided by a company measure (such as economic benefits)

20% cap rate = 5x multiple (1 ÷ 5 = 20%)

$10 of income ÷ 20% = $50 of value, or $10 of income x 5.0 = $50 of value

H. Discount for Lack of Marketability - an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability (the ability to quickly convert property to cash at minimal cost)

I. Discount for Lack of Control - An amount or percentage deducted from the pro rata share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control.

XII. References

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C. American Institute of Certified Public Accountants, Inc. (2007) *AICPA Statement on Standards for Valuation Services – Valuation of A Business, Business Ownership Interest, Security, or Intangible Asset*. New York: American Institute of Certified Public Accountants, Inc.

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# Valuing Real Estate Holding Companies

October 30, 2015

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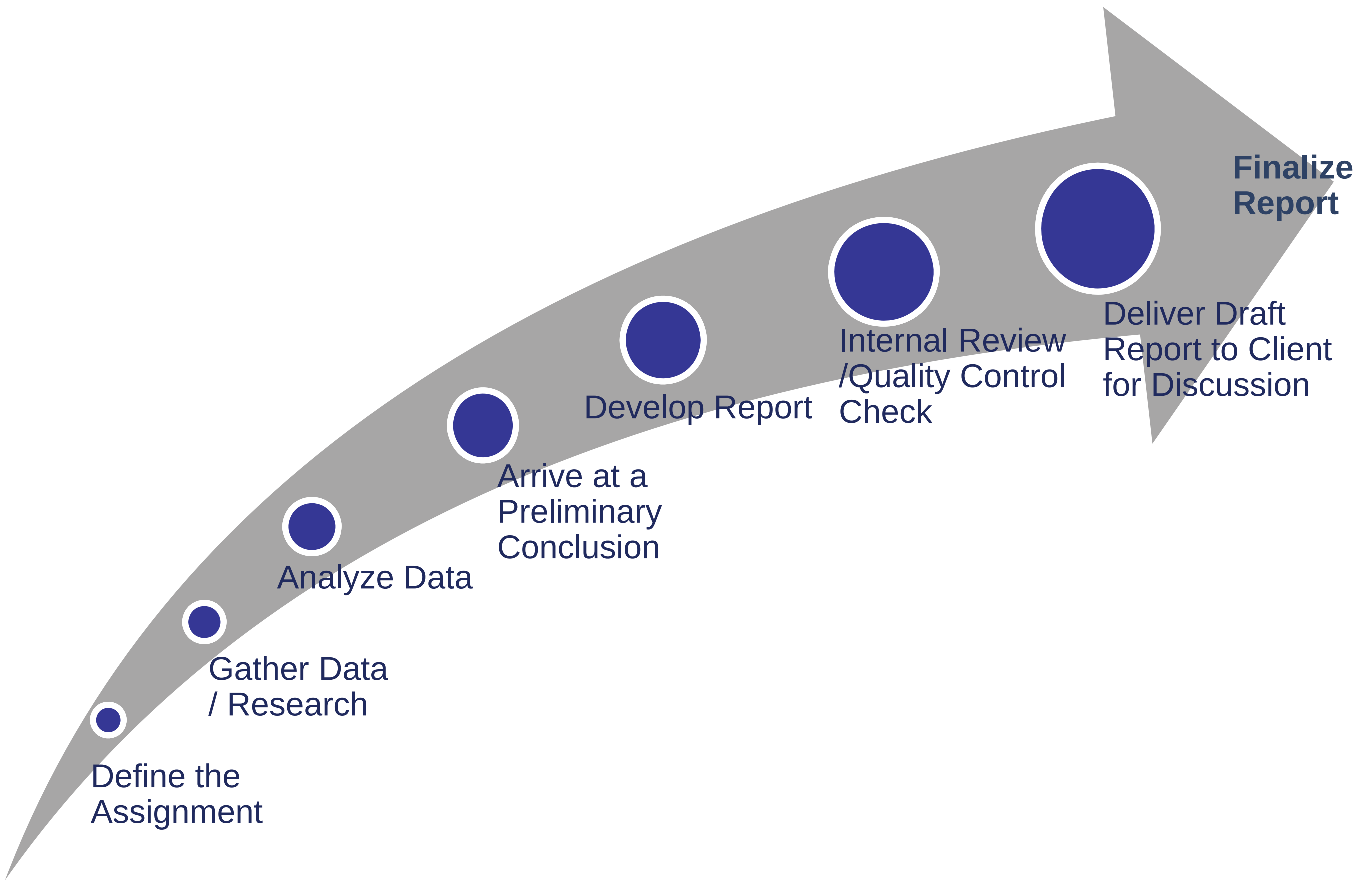
# Typical Valuation Process



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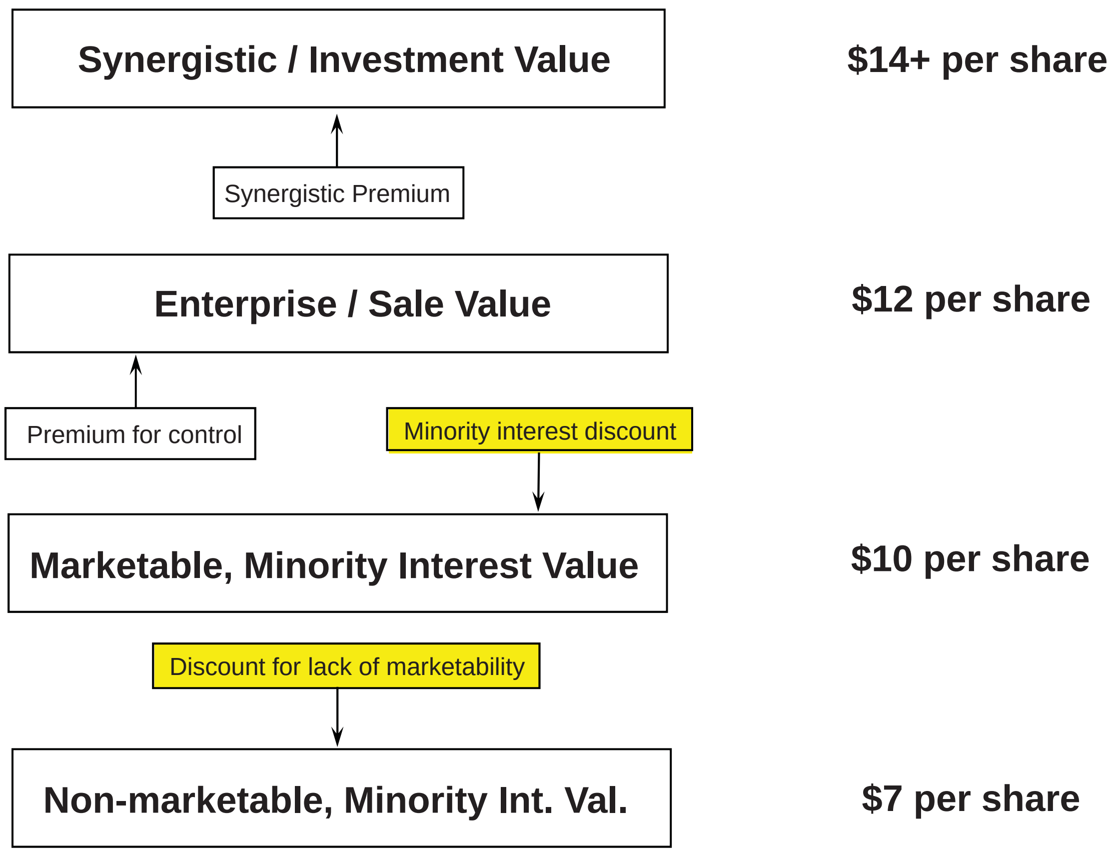
# Defining Value

- Premise of Value (Going Concern versus Liquidation)
- Standard of Value
  - –Fair Market Value
  - –Fair Value
  - –Investment Value (specific investor)
- Level of Value (Control versus Minority)
  - –Prerogatives of Control (set compensation, set distribution policy, make acquisitions or divestitures, sell the Company or its assets, set strategic policy, take on debt, etc.)

# Levels of Value - Discounts and Premiums



# Primary Valuation Methodologies

**Valuation Methodologies**

- **Income Approach** - focuses on the income or cash flow producing capability of the subject company or asset
  - Discounted Cash Flow Analysis
  - Capitalization of Income (Cash Flow)
- **Market Approach -** measures value based on the trading price or transaction price for similar companies or assets
  - Guideline Company
  - Guideline Transaction
- **Asset or Cost Approach -** is based on the premise that an investor would only pay for the replacement or reproduction cost of a company or an asset
  - Adjusted Book Value
  - Net Asset Value
  - Replacement Cost

# Valuing a Real Estate Holding Company

- An income approach or an asset approach may be employed
  - –Oftentimes a real estate appraisal is prepared for the underlying real property
  - –The RE Appraisal is then used as an input to the asset approach (i.e., adjusted book value method)
  - –With small minority interests it may be appropriate to utilize an income approach
- A secondary method may be used as a reasonableness assessment
  - –Implied yield analysis relative to market benchmarks
  - –Implied price per square foot comparison
  - –Implied cap rate comparison

# Valuing a RE Holding Co – ABV Analysis

- The Company's balance sheet is spread and analyzed (along with other historical financial data)
- The Company's assets and liabilities are adjusted to market value
  - –Adjustments include off-balance sheet, intangible, and contingent items
  - –The primary adjustment is oftentimes the estimated market value of the underlying real property
- The aggregate ABV is calculated by subtracting the market value of the liabilities from the market value of the assets
- Consideration is given to a discount for lack of control for non-controlling interests
  - –Various market based benchmarks are utilized to develop a discount for lack of control
- Consideration is given to a discount for lack of marketability to reflect the illiquidity of the underlying interest
  - –Qualitative and quantitative models may be employed

# Factors Impacting Marketability Discount

- Expected timing and amount of distributions
- Likelihood and timing of liquidation/exit events
- Ownership rights
- Put option rights
- Ability to transfer or withdrawal
- Other restrictions in the operating/partnership agreement
- Built-in capital gains in C-corp. holding companies

# Sample ABV Calculation & Application of Discounts

| CALCULATION OF ADJUSTED BOOK VALUE ("ABV") | | | |
|---|---|---|---|
| Real Estate Holding Company | | | |
| AS OF SEPTEMBER 30, 2015 | | | |
| | 9/30/15 | MARKET ADJUSTMENTS | ADJUSTED BOOK VALUE |
| **ASSETS** | | | |
| Cash and Equivalents | 750,000 | 10,000 | 760,000 |
| Prepaid Expenses and Other Assets | 120,000 | | 120,000 |
| **Total Current Assets** | 870,000 | 10,000 | 880,000 |
| Property # 1 | 350,000 | 250,000 | 600,000 |
| Property # 2 | 1,000,000 | 500,000 | 1,500,000 |
| Property # 3 | 800,000 | 200,000 | 1,000,000 |
| Machinery and Equipment | 85,000 | (40,000) | 45,000 |
| Total | 2,235,000 | 910,000 | 3,145,000 |
| Less: Accumulated Depreciation | (1,400,000) | 1,400,000 | 0 |
| **Net Fixed Assets** | 835,000 | 2,310,000 | 3,145,000 |
| Note Receivable, Shareholders | 500,000 | | 500,000 |
| Investments | 100,000 | 25,000 | 125,000 |
| Other Assets | 800,000 | (50,000) | 750,000 |
| **Total Other Assets** | 1,400,000 | (25,000) | 1,375,000 |
| **TOTAL ASSETS** | 3,105,000 | 2,295,000 | 5,400,000 |
| **LIABILITIES** | | | |
| Accrued Expenses and Taxes | 3,000 | | 3,000 |
| Notes Payable to Shareholders | 200,000 | (10,000) | 190,000 |
| **Total Current Liabilities** | 203,000 | (10,000) | 193,000 |
| Mortgage | 800,000 | (50,000) | 750,000 |
| **Total Other Liabilities** | 800,000 | (50,000) | 750,000 |
| **TOTAL LIABILITIES** | 1,003,000 | (60,000) | 943,000 |
| Common Stock | 100,000 | | 100,000 |
| Retained Earnings | 2,002,000 | 2,355,000 | 4,357,000 |
| **Total Shareholders' Equity** | 2,102,000 | 2,355,000 | 4,457,000 |
| **TOTAL LIABILITIES & SHAREHOLDERS' EQUITY** | 3,105,000 | 2,295,000 | 5,400,000 |
| **Adjusted Book Value ("ABV")** | | | **$4,457,000** |
| **Pro Rata ABV of Subject Interest** | | 12% | **$534,840** |
| Less: Lack of Control Discount | | 10% | (53,484) |
| Fully Marketable Non-Controlling Equity Value | | | 481,356 |
| Less: Discount for Lack of Marketability | | 30% | (144,407) |
| Aggregate Fair Market Value | | | **$336,949** |
| **Aggregate Fair Market Value, Rounded** | | | **$337,000** |



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# Factors affecting the Value of a RE Holding Co

- External Factors - factors that are beyond the control of owners / management
  - interest rates
  - market rates (yields, cap rates, discount rates)
  - debt financing costs
  - market and regional economic conditions
  - level of competition
  - government regulation/policies
- Internal Factors - factors that owners / management can control or influence
  - condition of books and records
  - property/facility conditions
  - discretionary costs
  - financial leverage
  - management fees/perquisites
- Synergy
  - When the union of two parts is greater than the sum of the two parts. The expected synergy achieved through a merger can be attributed to various factors such as increased revenue, combined talent and technology, or cost reductions
  - Generally not applicable in the context of FMV

## Other Valuation Issues

- Partial Interests (TIC) in Real Property
  - Cost to partition analysis (Ludwick case)
- Built-in Capital Gains
  - Valued as a Liability or dealt with through the application of discounts
  - Several court cases discuss the issue (Jensen; Jameson; Eisenberg; and Davis cases)
  - Treatment may vary depending on the methodology employed and court jurisdiction
- S-corp./Pass-through Entity Adjustment
  - Relevant when valuing minority interests
  - May be applicable when using an income approach
  - May not be applicable when using an Asset Approach, if similar types of pass through entities are used for benchmarking

# Real Estate Valuation for Estates & Gifts
# The Requirements and Process

2015 New York State Bar Association
Trusts and Estates Law Section Fall Meeting
Presentation by:


**Kevin L. Bruckner MAI, CCIM**

Bruckner, Tillett, Rossi, Cahill & Associates
500 Linden Oaks, Suite 130
Rochester, New York 14625
(585) 383-4501


i. Appraiser Independence
   a. Appraisers <u>must</u> comply with the Uniform Standards of Professional Appraisal Practice (USPAP) and certify that…
      i. Our opinions, analysis and conclusions are our own personal unbiased professional opinions, analysis and conclusions
      ii. We have no interest or bias in the real property or parties involved
      iii. Our conclusions are not contingent upon the fee or predetermined results
   b. As an MAI member of the Appraisal Institute, MAI's must comply with the Code of Professional Ethics and the Standards of Professional Appraisal Practice of the Appraisal Institute
ii. Highlights of IRS Pub 561
   a. The valuation of Real Estate considers three approaches to value
      i. Comparable Sales Approach
      ii. Capitalization of Income Approach
      iii. Replacement Cost New or Reproduction Cost New Minus Observed Depreciation Approach (Plus land value)
   b. Qualifications and Other Requirements
      i. The appraiser must be thoroughly trained in the application of appraisal principles and theory
      ii. The appraisal report must contain a complete description of the property, such as street address, legal description, and lot and block number, as well as physical features, condition, and dimensions. The use to which the property is put, zoning and permitted uses, and its potential use for other higher and better uses are also relevant

iii. What is a Qualified Appraisal
   a. Is made, signed, and dated by a qualified appraiser (defined later) in accordance with generally accepted appraisal standards
   b. Meets the relevant requirements of Regulations section 1.170A-13(c)(3) and Notice 2006-96, 2006-46 I.R.B. 902
   c. Relates to an appraisal made not earlier than 60 days before the date of contribution of the appraised property
   d. Does not involve a prohibited appraisal fee, and
   e. Includes certain information (covered later)

iv. Highlights of IRS Bulletin 2006-46
   a. This bulletin seeks to further clarify a Qualified Appraisal and Appraiser
   b. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of § 170(f)(11)(E)(i)(II) if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation
   c. An appraiser will be treated as having earned an appraisal designation from a recognized professional appraiser organization within the meaning of § 170(f)(11)(E)(ii)(I) if the appraisal designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed

v. Other Information Required per IRS Requirements
   a. A sufficient description of the property and its condition
   b. The date (or expected date) of contribution,
   c. The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor that relates to the use, sale, or other disposition of the donated property.
   d. The name, address, and taxpayer identification number of the qualified appraiser
   e. The qualifications of the qualified appraiser
   f. A statement that the appraisal was prepared for income tax purposes,
   g. The date (or dates) on which the property was valued,
   h. The appraised FMV on the date (or expected date) of contribution,
   i. The method of valuation used to determine FMV, such as the income approach, the comparable sales or market data approach, or the replacement cost less depreciation approach, and
   j. The specific basis for the valuation, such as any specific comparable sales transaction.

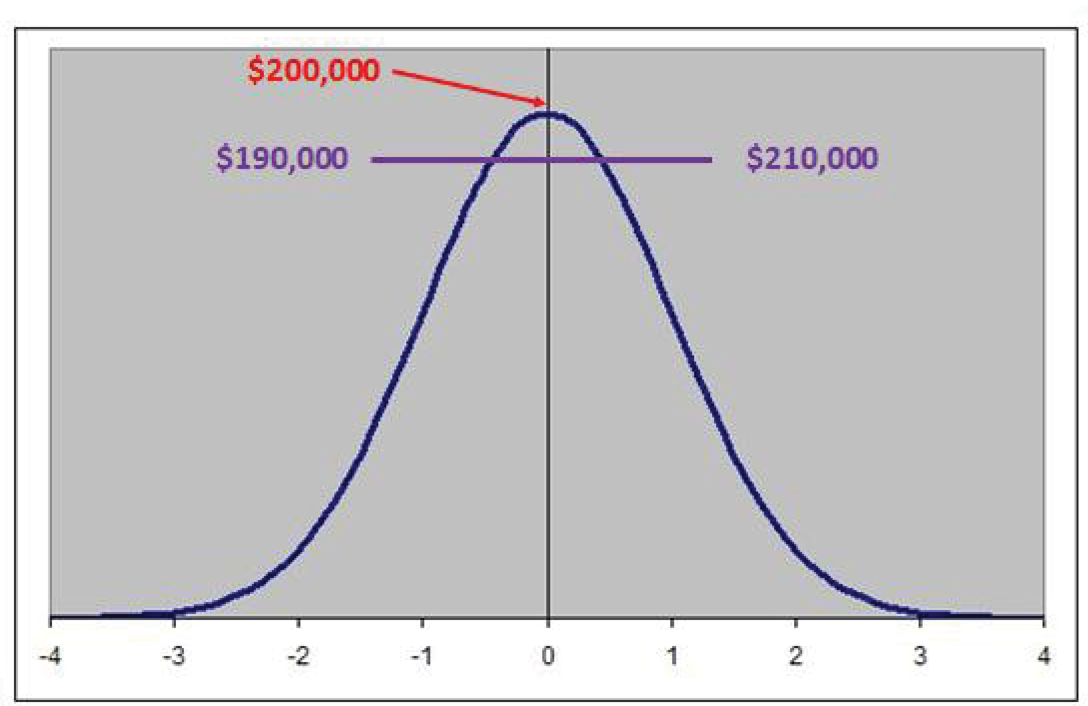
vi. Requirements to provide a quote for real estate appraisal services
   a. Specifically identify the property or properties involved in the estate or gift (street address is best)
   b. Provide a brief physical description of the property and its occupancy
   c. What is the date of valuation?
   d. When do the final reports need to be completed?

e. Will I be able to fully inspect the property and will financial information be readily available?
f. Are there any other known considerations that may impact the valuation or analysis that I should know?

vii. Market Value

a. Market Value is generally defined as the <u>most probable</u> sales price in terms equivalent to cash on the date of valuation that a property will sell under all conditions of a fair sale.
b. Does an appraisal identify a single estimate of value? YES
c. Can appraisals/appraisers be that precise? NO
d. Do all properties have a range of value? YES
e. Why? Because Real Estate Markets are imperfect!
f. What is an acceptable range of value?
   i. Within 1%+/- is excellent
   ii. Within 3%+/- is good
   iii. Within 5%+/- is acceptable but in most cases the maximum

viii. The Bell Curve and Value




ix. Draft to Final Report

a. I prefer to communicate my preliminary values or send a draft of my report to the client prior to completion
b. A thorough reading and review of the draft is crucial by the client and/or attorney
c. We can then address any questions, issues or concerns
d. Remember we are working as a team
e. The final report is delivered and the appraiser signs the tax return

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# Highlights of IRS Pub 561

- The valuation of Real Estate considers three approaches to value
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- Qualifications and Other Requirements
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# I’d Like to Get a Quote!

- ❑Specifically identify the property or properties involved in the estate or gift (street address is best)
- ❑Provide a brief physical description of the property and its occupancy
- ❑What is the date of valuation?
- ❑When do the final reports need to be completed?
- ❑Will I be able to fully inspect the property and will financial information be readily available?
- ❑Are there any other known considerations that may impact the valuation or analysis that I should know?

# The Proverbial Comment

- Since this is an estate appraisal, we're looking for a LOW value!
- Since this is an appraisal for gifting, we're looking for a HIGH value!
- My response, "I understand, but…!"

# Market Value

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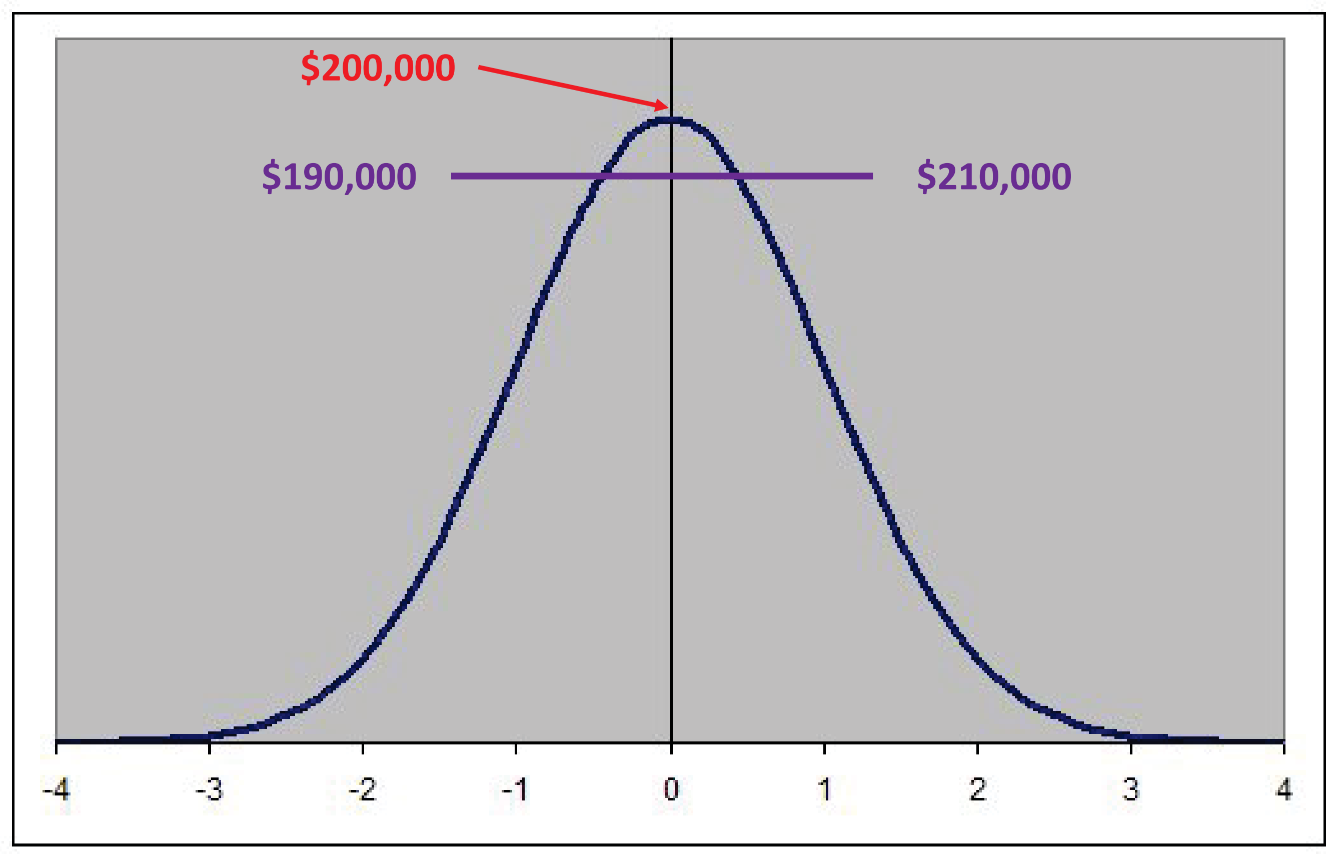

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- Remember we are working as a team
- The final report is delivered and the appraiser signs the tax return

I’d be happy to answer any general valuation questions as part of this panel discussion and will be available for any specific valuation questions following this panel discussion.

THANK YOU