SPECIAL SECTION:
VALUATIONS

By Timothy J. Meinhart

Valuation of Preferred Equity Interests In Estate Planning

A review of characteristics that drive value

Preferred equity interests have been used for several decades to accomplish certain estate-planning objectives. The characteristics of preferred interests—such as those related to dividend rights, liquidation rights and voting rights—tend to be the primary value drivers of these senior equity interests.

In the years prior to the enactment of Chapter 14 of the Internal Revenue Code in 1990, estate planners had a fair degree of flexibility in structuring a transaction in which an entity was capitalized (or recapitalized) with preferred equity interests. However, following Chapter 14, estate planners were required to re-evaluate how to properly structure certain family transactions involving preferred equity interests to avoid adverse transfer tax consequences. While the use of preferred interests in estate planning has varied over the years—namely with fluctuations in market yields—preferred securities have proved to be a staple in many estate planners' tool kit.

While market yields for certain fixed income investments have increased over the past year, it's noteworthy that market yields of both high and low investment grade preferred equity interests haven't experienced as severe of an increase in their yields. The relatively low market yields associated with preferred interests have kept the senior equity interests at the forefront when estate planners discuss certain estate and gift tax planning techniques with their clients. The relatively low market yields are particularly helpful from a valuation standpoint when senior family members retain preferred interests and transfer the higher growth nonpreferred equity interest to their heirs.

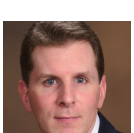
Let's look at the basic preferred equity interest characteristics that drive value and review the procedures used to value preferred interests, valuation guidance provided by the Internal Revenue Service and the current interest rate environment for preferred equity interests.

Preferred Interests

Preferred equity interests generally have special features that aren't typically associated with common (that is, nonpreferred) equity interests. Many of these features are designed to offer downside protection to the preferred shareholders if the subject entity experiences financial hardship. In return for this downside protection, the preferred equity holder typically forfeits most, if not all, upside related to the growth of the subject entity and its shareholder equity. Such growth typically accrues entirely to the common equity holders.

Here are some of the more common features of preferred equity interests. Each of these features could have a significant impact on how the security is valued for a particular estate-planning transaction.

- **Dividend rate—**Preferred interests are typically structured with either a fixed rate dividend or an adjustable rate dividend. Fixed rate dividends are usually stated as a fixed dollar amount or a fixed percentage of the interest's par (or stated) value. The fixed rate dividends are typically paid on a quarterly, semi-annual or annual basis. In contrast, other preferred interests may be structured with an adjustable rate dividend. Adjustable rate dividends may be tied to movement



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in a specific market index or security, or the dividend rate may simply change at certain dates due to the contractual terms of the equity interest. In general, and all else being equal, adjustable rate preferred interests have a lower dividend yield than fixed rate preferred interests. However, the spread between the yields on adjustable rate preferred interests and fixed rate preferred interests will often fluctuate with movement in market interest rates on other fixed income investments.

- **Cumulative vs. noncumulative dividends—**A cumulative preferred interest, unlike a noncumulative preferred interest, offers a fair degree of dividend protection to the preferred interest holders. The cumulative nature of a preferred interest requires that any preferred dividends for prior periods that haven't been paid by the entity must be paid before the entity declares and pays any dividends on its common equity interests or other junior (that is, nonpreferred equity) interests. The cumulative nature of the dividends requires that the preferred interest holders don't suffer a loss in income unless the entity is eventually unable to pay the cumulative amount. Most cumulative preferred interests require that accrued and unpaid dividends are paid at liquidation with the preferred interest's liquidation preference before any entity assets are available for distribution to holders of junior equity interests. In contrast, noncumulative preferred interests, which rarely exist in the private and public markets, require that the preferred interest holders assume significant dividend risk, not unlike the risk that's assumed by common equity holders. In general, and all else being equal, a noncumulative preferred interest will have a higher yield (and a lower resulting value) than a cumulative preferred interest to account for the additional dividend risk that's borne by the noncumulative preferred interest holders.
- **Liquidation preference—**One of the most common features that distinguishes a preferred equity interest from a nonpreferred equity interest is the presence of a liquidation preference. Most preferred interests have a contractual right (or preference) in the distribution of an entity's assets on liquidation. In most cases, this liquidation preference is stated as a certain dollar amount per share or an aggregate dollar amount for the entire preferred interest. While a liquidation preference may provide preferred equity interest holder protection in the case of a liquidation—assuming the entity has sufficient assets to satisfy the preference—it's important to note that many preferred interest issues don't have sufficient voting rights to force an entity liquidation. As a result, with entities that are performing adequately, the liquidation preference of the preferred interest may never be triggered. Also, the liquidation preference is only as good as the entity's ability to pay the preference. The stated dollar amount of the liquidation preference and its relative portion of the total entity equity value are often key considerations in structuring a new class of preferred interests.
- **Conversion rights—**One of the most valuable features of certain preferred interests is their ability to be converted into a common equity interest. Convertible preferred interests are often thought of as two investment interests in one. First, the interest holder is entitled to a preferred dividend and a liquidation preference, which makes the security similar to an ordinary nonconvertible preferred security. However, the conversion feature provides the interest holder an option to participate in the growth that would typically accrue solely to the common equity owners. Most

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conversion features provide the right, but not the obligation, for the preferred equity holder to convert its preferred interest into a common equity interest. In general, and all else being equal, a convertible preferred interest will require a lower dividend yield than the yield on nonconvertible preferred interests. Furthermore, the valuation of a convertible preferred interest is often a complex exercise because its value is driven by a combination of: (1) its stated dividend percentage, (2) market yields for similarly situated preferred interests, (3) the conversion rights of the interest, and (4) the price/value of the underlying common equity interest into which the preferred interest converts.

Whether the issuing entity will be able to pay the full liquidation preference of the preferred interest at the date of liquidation should be considered in determining fair market value.

- **Voting rights—**While many publicly traded preferred securities don't carry voting rights, it's fairly common to see preferred interests in privately held entities that were structured with voting rights. Voting rights of preferred interest often go hand in hand with the interest's other features. For example, a preferred interest with a noncumulative dividend may have voting rights to potentially offset the value decrement associated with the noncumulative nature of the dividends. While voting rights will typically increase the value of the preferred interest, all else being equal, the degree of control conveyed by the voting rights typically dictates the magnitude of the increase in value. We would expect a much lower increase in value if the preferred interest holders accounted for only a fraction of the total voting rights of the entity, while a preferred interest block that accounted for all of the voting rights would typically justify a higher increase in value.
- **Call rights and put rights—**Most preferred interests are noncallable (that is, nonredeemable) and considered to be perpetual in nature. However, some preferred interests, particularly in the case of nontraded preferred interests, grant the issuing entity the right to redeem the preferred interest at a predetermined price over a specified period of time or on the occurrence of a specific event. The effect that this call feature has on the value of the preferred interest varies based on the terms of the redemption provisions. Alternatively, a nontraded preferred interest may be structured with a put right, or a series of put rights, that gives the interest holder the right, but not the obligation, to sell the interest to the issuing entity at a predetermined price over a specified period of time or on the occurrence of a specific event. While structuring a preferred equity interest with put and/or call features was fairly common in the 1980s, certain changes in the Tax Code, namely the addition of Chapter 14 in 1990, reduced the effectiveness of certain put and call features, particularly in the context of estate-planning transfers. In general, and all else being equal, a call right will generally reduce the value of the preferred interest, and a put right will generally increase the value of the interest.

Each of the above-described features needs to be evaluated when structuring a preferred equity interest. The large availability of customizable features gives the estate planner maximum flexibility when deciding how to create a series of preferred interests that will achieve a certain estate-planning/transfer tax goal.

Valuation Methods and Procedures

In simplest terms, a common nonconvertible preferred interest can be thought of as a fixed income security that pays the security holder a fixed dividend payment in perpetuity. In that regard, the current value of the preferred equity interest can be estimated as the present value of the future income stream. Stated another way, the future preferred dividend payments, discounted to the present at a risk-adjusted

rate of return, provide an indication of the price an investor would pay for the preferred interest.

For most conventional preferred equity interests, a projection of the interest's future dividend stream is easy to estimate. For example, a noncallable 10 percent preferred equity interest with a par value of $100 is expected to pay a $10 dividend in perpetuity (that is, 10 percent x $100). The more difficult exercise is determining the proper rate of return, or yield, to use in discounting the future dividend stream to a present value. The yield is often established by reviewing market yields of other similar, but publicly traded, fixed income securities.

The general procedures for valuing nonpublicly traded preferred interests, particularly in the context of estate-planning transfers, are:

- Evaluate the rights and features of the subject preferred interest. This includes an evaluation of rights related to dividends, liquidation, conversion, voting and redemption.
- Evaluate the credit quality of the subject preferred interest. While the subject preferred interest may not be rated by a credit rating agency, the analyst can develop a synthetic credit rating for the equity interest by analyzing certain coverage ratios related to dividends and liquidation.
- Identify publicly traded fixed income securities—preferably, publicly traded preferred securities—that have similar features and credit quality as the subject preferred interest.
- Extract a representative market-derived dividend yield from the comparable preferred securities, and apply the yield to the dividend stream of the subject preferred interest.

Revenue Ruling 83-120

These generally accepted procedures for valuing preferred interests have stood the test of time and are supported by the guidance given by the IRS 35 years ago when it issued Rev. Rul. 83-120. That ruling continues to be the primary regulatory guidance that's followed today regarding the valuation of preferred equity interests for gift and estate tax planning purposes.

Rev. Rul. 83-120 was issued to amplify Rev. Rul. 59-60 by specifying additional factors to be considered in valuing common and preferred equity interests of a closely held entity for gift tax and other purposes in a recapitalization of the entity. According to Rev. Rul. 83-120, in general, the most important factors to be considered in estimating the value of preferred equity interests are: (1) its yield, (2) its dividend coverage, and (3) protection of its liquidation preference.

- **Yield—**Whether the stated yield of the preferred interest supports a valuation of the interest at par value depends in part on the adequacy of the dividend rate. The adequacy of the dividend rate should be determined by comparing its dividend rate with the dividend rate of high grade publicly traded preferred securities. A yield lower than that of high grade preferred securities indicates a preferred interest value of less than par and vice versa.
- **Dividend coverage—**The actual dividend rate on a preferred interest can be assumed to be its stated rate if the issuing entity will be able to pay its stated dividends in a timely manner and will, in fact, pay such dividends. The risk that the entity may be unable to timely pay the stated dividends on the preferred interest can be measured by the coverage of such stated dividends by the entity's earnings. Inadequate coverage exists when a decline in profits would be likely to jeopardize the entity's ability to pay dividends on the preferred interest. Inadequate coverage may indicate that the value of the preferred interest is lower than its par value. Moreover, the absence of a provision that preferred dividends are cumulative raises questions concerning whether the stated dividend rate will, in fact, be paid.
- **Liquidation preference—**Whether the issuing entity will be able to pay the full liquidation preference of the preferred interest at the date of liquidation should be considered in determining fair market value. This risk can be measured by the protection afforded by the entity's net assets. Inadequate asset protection exists when any unforeseen business events would be likely to jeopardize the entity's ability to pay the full liquidation preference to the holders of the preferred interests.

Rev. Rul. 83-120 states that: (1) voting rights, and (2) redemption privileges are also factors

to consider in the valuation of preferred equity interests.

Enactment of Chapter 14

Any discussion of the valuation of preferred interests in the context of estate planning would be incomplete without mentioning Chapter 14, specifically IRC Section 2701,[1] and considering why Congress enacted these IRC provisions.

Prior to the enactment of Chapter 14, Congress was concerned with the alleged undervaluation of preferred equity interests in the context of estate "freezes." The objective of an estate freeze is to essentially reduce the value of an ownership interest for estate tax purposes by having senior family members retain nonappreciating equity interests while simultaneously transferring appreciating equity interests of the same business to junior family members.

A typical estate freeze would involve a recapitalization of an entity and a subsequent transfer of nonpreferred (that is, common) equity interests to junior family members while senior family members retained the preferred interest. In many instances, the entity was recapitalized with noncumulative preferred interests with a relatively high liquidation preference. These characteristics, as well as others, such as voting rights and redemption provisions, allowed for a relatively high portion of the entity value to be allocated to the preferred interests. By doing so, it meant a relatively low portion of the entity value was allocated to the common equity interests, which were the subject of the transfer. In most situations, the lower value on the common equity interests reduced the tax liability on the transfer of the junior equity interests. Also, the preferred nature of the security retained by the senior family member ensured that the security would have limited (if any) future growth in value, thereby limiting the future estate tax on the retained asset.

Following the transaction, the controlling shareholder—typically the preferred shareholder—operated the entity in a way that would suggest the preferred interests had minimal value, or at least value well below the value that was placed on the preferred interests for purposes of the transaction. The controlling equity owner would accomplish this by discontinuing the payment of a dividend on the preferred interest. Furthermore, because the preferred interest was noncumulative, there would be no accumulation of accrued and unpaid dividends. Given the unlikelihood of an entity liquidation and the lack of any current or accruing dividend on the perpetual preferred interests, a case could be made that the true value of the preferred interest was well below the value placed on it for purposes of the transaction.

To address these alleged abuses, as well as other matters, Congress enacted Chapter 14 and its special valuation rules, including those under Section 2701. These special valuation rules deal with, among other things, the rules that need to be followed when valuing senior, preferred equity interests in certain intrafamily transactions. More specifically, the special valuation rules of Section 2701 apply when a transfer of an interest in an entity (that is, a corporation or partnership) is made to a member of the transferor's family and, after the transfer, the transferor or an applicable family member holds an applicable retained interest in the entity.

While a detailed discussion of Section 2701 is beyond the scope of this article, it's important to note that an applicable retained interest is any interest that confers a discretionary liquidation, put, call or conversion right or a distribution right in a family-controlled entity. In determining the gift tax consequences of a transfer pursuant to Section 2701, a retained liquidation, put, call or conversion right is valued at zero. Furthermore, a retained distribution right in a controlled entity is also valued at zero, unless it's a right to a cumulative dividend payable on a periodic basis at a fixed rate or with reference to a specified market interest rate (that is, a qualified payment).

In short, since the enactment of Section 2701, most preferred interests have been structured with a cumulative preferred dividend that allows the preferred interests to be valued primarily on their stated annual dividend and current market yields. In contrast, creating a noncumulative preferred interest in the post-Section 2701 environment would usually result in no value being ascribed to the preferred interest retained by the senior family member, which may present adverse tax consequences in connection with the transfer of the junior equity interests.

Current Rate Environment

Preferred equity interests have proven to be effective securities for accomplishing certain estate-planning objectives. In any organization or reorganization of an entity, the planner is able to customize the features of the preferred interests, which, in turn, will influence their value either positively or negatively. This allows the estate planner to create equity securities that provide growth for one generation of the family and income and asset protection for another generation.

Given that privately held preferred interests are often valued by reference to market-based yields on publicly traded preferred interests, the current interest rate environment influences the effectiveness of using preferred interests in the estate-planning context. During 2018, several interest rates that are often referenced in estate-planning related valuations have increased. More specifically, as presented in "A Rising Rate Environment," this page, the yield on the 3-month, 6-month and 1-year U.S. Treasuries has increased 71 percent, 65 percent and 53 percent, respectively, from Jan. 1, 2018 through the end of November 2018.[2] Also, the short-term applicable federal rate (AFR) and mid-term AFR have increased 61 percent and 39 percent, respectively, over the same period. In contrast, the yield on both high investment grade and low investment grade preferred securities has increased only modestly since the beginning of the year. The yield of a subset of high investment grade and low investment grade cumulative preferred securities has increased only 22 percent and 27 percent, respectively, over the first 11 months of 2018.[3]

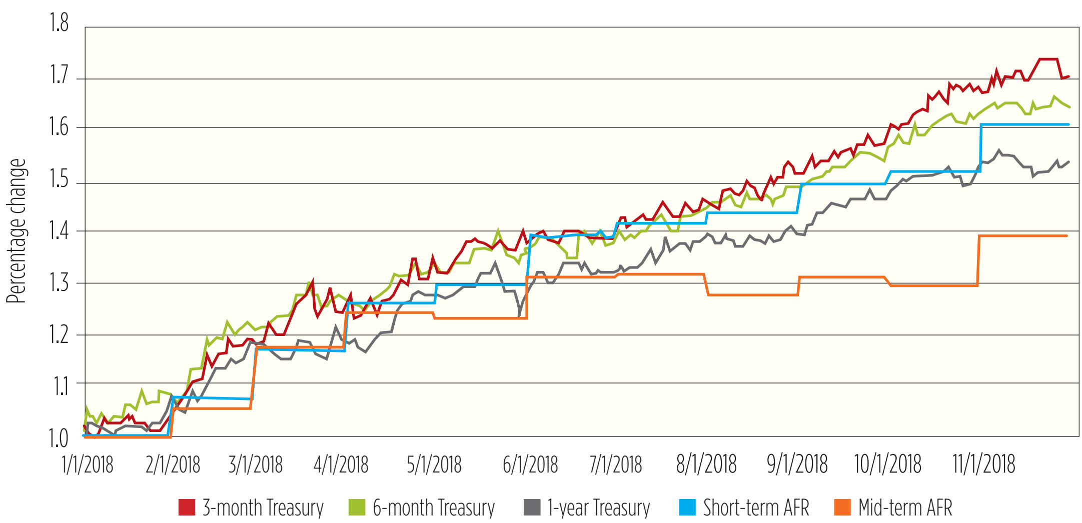
The relatively low yields of preferred interests in a rising interest rate environment have allowed these senior equity interests to retain their popularity, especially in the context of estate freeze transactions.

Endnotes

1. *See* Treasury Regulations Sections 25.2701-1 through 25.2701-2.
2. Daily market yields for U.S. Treasuries were provided by Capital IQ. Monthly applicable federal rates were provided by *https://apps.irs.gov/app/picklist/list/federalRates.html.*
3. Market yields on the subsets of high investment grade and low investment grade preferred securities were constructed using data from Bloomberg.

A Rising Rate Environment

The percentage change



AFR=Applicable federal rate

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