

By Barry A. Nelson & Michael S. Piowar



Custom Bond Valuations Can Save Clients Money

Institutions get higher prices for bonds than individuals—yet standard bond valuations are based on the institutional prices. The result: individuals can pay unnecessarily high estate taxes. Time to stop that

Barry A. Nelson, a Florida bar board certified tax attorney in the North Miami Beach, Fla., writes:

Recently, I was approached by the personal representative for an estate of a wealthy decedent that owned a significant municipal bond portfolio. The representative was concerned because each time he redeemed the decedent’s municipal bonds, the sales proceeds were 2 to 3 percent less than the appraised value obtained from a valuation service used for the decedent’s estate tax return. He could not understand why he should be forced to pay estate taxes on phantom value.

How is it that a nationally recognized appraisal company reported values that were several percentage points higher than what the representative was able to recover selling the bonds? The answer, we learned, is that on any given date the actual price at which the representative could actually sell the bonds was consistently lower than the price that would be reflected by most qualified appraisal services.

We tracked down an economist who could explain and help us with this problem: Michael Piowar, a principal at Fairfax, Va.’s Securities Litigation and Consulting Group, Inc. Armed with Piowar’s analysis, we were able to have the bonds revalued at about that same price at which the personal representative was

able to sell them. The revised appraisal resulted in a significant tax savings for the estate. We believe that many taxpayers with large municipal or corporate bond holdings may find that the concepts and remedies discussed here will result in significant tax savings.

Michael S. Piowar, who has a doctorate in finance, writes:

There are just a few key points that advisors and personal representatives need to know on the path to estate tax savings with bond valuations. First, the Internal Revenue Service uses selling prices to determine the fair market value (FMV) of a bond.

Estates containing bonds must file a Schedule B with the Form 706 estate tax return.¹ The instructions for filing Schedule B, governed by Section 20.2031-2 of the estate tax regulations of the Internal Revenue Code, describe how to calculate the FMV of a bond on the valuation date.²

If a bond traded in the secondary market on the valuation date, then the FMV is determined by taking the mean (average) between the highest and lowest selling prices. But, if the bond did not trade on the valuation date, then the FMV is calculated according to an “inverse weighting” scheme that takes into account how close transactions occur relative to the valuation date.

Second, advisors must know that individual investors consistently receive lower selling prices on their bonds than institutional investors.

Investors who trade bonds with dealers pay trading costs for the intermediary services that the dealers provide. In the U.S. municipal and corporate bond markets, the vast majority of trading costs are charged as markdowns and markups. Bond dealers charge markdowns when purchasing bonds from customers



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and markups when selling bonds to customers.

Markdowns and markups do need to be disclosed on customer confirmations. Unsophisticated individual investors who pay hidden markdowns and markups may mistakenly conclude that they are not incurring any trading costs. They would be wrong. The hidden markdowns are reflected in the prices that investors receive for their bonds and the hidden markups are reflected in the prices that investors pay for their bonds.

Recent published academic research confirms what sophisticated traders already know.³ Large institutional investors (that is to say, mutual funds, pension funds, hedge funds, etc.) who sell large institutional-sized bond positions are consistently able to negotiate lower markdowns/markups on their bond trades. In other words, **market professionals who sell large institutional-sized positions receive better (that is to say higher) prices for their bonds than individual investors who sell small retail-sized positions.**

But, because most individuals who hold bonds are not sophisticated traders, most investors are unaware that they consistently receive lower selling prices on their bonds than institutional investors. To illustrate, consider the following example. Suppose that a liquid bond is trading a prevailing market price of about \$100 to \$101. A dealer might be willing to buy \$1 million worth of the bond from its institutional customers for \$100 and sell it at \$101. For each round-trip institutional transaction, this dealer would make a trading profit of \$1 or about 1 percent.

Now, suppose that an individual investor wants to sell a \$25,000 position. Would the dealer give the individual investor trading a small position the same price (\$100) as he gave the institutional investor trading a large position? Almost certainly not. More likely, the individual investor would be offered a much lower selling price.

How much lower? It is not uncommon to see a retail price discount of 2 percent or more in the municipal and corporate bond markets. Continuing with our example, a dealer might be willing to buy small retail-sized positions at \$98.

In this example, a bond valuation based on an institutional selling price would calculate an FMV of \$100, while a bond valuation based on a retail selling price would calculate an FMV of \$98. For the estate of an individual investor with retail-sized bond positions, the FMV based on retail selling prices would be more appropriate than one based on institutional selling prices.

Third, despite this gap between the prices that institutions and individuals can negotiate, **standard bond**

Individuals who use standard bond valuations based on institutional prices are paying unnecessarily high estate taxes.

valuations of individuals' bond portfolios are usually based on institutional prices. Indeed, bond valuations typically use data from institutional pricing services that provide pricing information to the institutional investment community. For instance, FT Interactive Data is a leading source of pricing data for global financial institutions to value bonds and other asset classes. FT Interactive Data describes its pricing services as representing its "good faith opinion as to what a buyer in the marketplace would pay for a security (typically in an institutional round lot position) in a current sale."⁴ Thus, for investors who hold institutional round lot positions (for example \$100,000, or more), standard bond valuations based on prices provided by an institutional pricing service can provide an accurate appraised value (FMV) for a decedent's estate tax return.

But, most individual investors do not hold institutional round lot bond positions. Even well-to-do clients with very large bond holdings typically split their holdings across many different bonds. Therefore, **individual investors who use standard bond valuations based on institutional prices are paying unnecessarily high estate taxes.**

Finally, this problem can be corrected with custom

bond valuations, which can incorporate the actual selling prices of individual transactions.

Regulatory initiatives in the past few years have brought unprecedented price transparency to the municipal and corporate bond markets.⁵ Reported bond prices for virtually all municipal and corporate bonds are now available for those who know where to find them and how to use them. Economic experts have developed methods for uncovering the (sometimes hidden) costs of trading bonds. For estate tax valuations, these methods are useful in incorporating actual selling prices of individual retail-sized transactions into custom bond valuations.

Armed with actual retail selling prices, economists can perform custom bond valuations for estates containing retail-sized bond positions. With these custom bond valuations, well-to-do clients of estate tax attorneys can realize significant estate tax savings.

To illustrate, consider the following real-life example involving a client with a retail-size (40-bond) position of a municipal bond issue. The standard bond valuation yielded an appraised value on the valuation date of \$107.54. A custom bond valuation showed that the sale by a customer that occurred on the closest date before the valuation date took place about one month before the valuation date for a 100-bond position at a price of \$106.18 per bond. Thus, the standard bond valuation of \$107.54 based on data from an institutional pricing service yields an FMV that is higher than the most recent selling price. Moreover, the selling price of \$106.18 was received by an investor who sold a large (100-bond) institutional-sized bond position.

What did investors who sold retail-sized bond positions of this bond issue receive near the valuation date? A custom bond valuation showed that there were no retail-sized (less than 100 bonds) customer sales within the two months prior to the valuation date, but two weeks after the valuation date, a customer sold a 50-bond position at \$105.13. In accordance with IRS estate tax regulations, we assigned an FMV of \$105.13, which resulted in a discount of 2.2 percent from the standard bond valuation's \$107.54 fair market value

calculation. At a 45 percent estate tax rate, the custom bond valuation discount on this bond position resulted in a tax savings of about \$433.⁶

Also Consider

While estate tax regulations explicitly allow for valuations to be based on trades that occur (within a reasonable period) after the valuation date, standard valuations based on institutional pricing services do not incorporate this information. The following scenarios provide two examples of how this omission could lead to unnecessarily high estate tax valuations:

- **Negative information about the issuer.** Suppose a client holds an infrequently traded bond that is valued at \$95 by an institutional pricing service; let's say this value is based upon the most recent institutional trade that occurred four trading days earlier. On the valuation date, suppose that negative information about the issuer (or the issuer's bond insurer) is disclosed to the market, but there are no bond sales on that day. The following day, there are bond sales and the negative information is reflected in actual selling prices that average \$90. A standard bond valuation would assign the institutional pricing service value of \$95. But a custom bond valuation could incorporate the actual selling prices that occur the day after the valuation date, in accordance with the IRC, and value the bond at \$91 ($\$91 = [(1 \times \$95) + (4 \times \$90)]/5$). Thus, a custom estate valuation would result in a 4.21 percent discount. At an estate tax rate of 45 percent, this would result in tax savings of 1.9 percent.

- **Downward price trends.** Standard bond valuations may not always accurately capture downward price trends for high-coupon premium bonds. For example, suppose a client holds a high-coupon bond with a relatively short time until maturity. On average, the price of this bond is expected to decline steadily toward par (\$100) at maturity. If the bond has not traded for a few weeks and there are no "similar" bonds from which to generate a matrix price, the price used in a standard bond valuation may not capture all (or any) of the

appropriate downward price trends. But a custom bond valuation, could incorporate the lower selling prices that occur within a reasonable period after the valuation date, leading to a lower FMV and an associated tax savings.

Consider another real-world example from a client with a small position (20 bonds) in a municipal bond issue. The standard bond valuation appraised this bond at \$133.14. A custom bond valuation showed that the trades for this bond that occurred on the closest dates before the valuation date were inter-dealer transactions occurring at prices between \$131 and \$132. At first glance, the standard bond valuation of \$133.14 looks like it yields an estimate of the FMV of the bond that is only slightly too high. But the custom bond valuation yielded two important results that showed that standard bond valuation yielded an appraisal that was much too high.

First, the trades that occurred on the closest dates before the valuation date occurred nine months before the valuation date. In other words, this very illiquid bond had not traded at all for nine months. Thus, the actual selling prices that were received by customers before the valuation date were very stale.

Second, shortly after the valuation date, the bond finally traded again. A quantity of 25 bonds was sold by a customer at \$118.25 per bond. In accordance with IRS regulations, we assigned an FMV of \$118.25, which resulted in a discount of 11.2 percent from the standard bond valuation's \$133.14 FMV calculation. At a 45 percent estate tax rate, the custom bond valuation discount on this bond position resulted in a tax savings for the client of about \$1,340.⁷

How Much Lower?

It is not uncommon to see at least a 1 to 2 percent custom valuation discount on most bonds, and 5 percent or more on some types of bonds. For a well-to-do client with a \$5 million bond portfolio, this can translate to an estate tax savings of about \$100,000 or more. (See "Custom Trumps Standard," p. 48)

The cost of a custom valuation varies. It depends

on the total number of bonds being valued and the rates charged by the firm providing the custom bond valuation service. In our experience, **most clients can expect the cost to be below \$10,000**. For some clients, the cost can be below \$5,000. Therefore, for clients with large municipal or corporate bond holdings, tax savings benefits can generally dwarf the modest costs of hiring an economic expert to perform a custom bond valuation.

Note, however, that **not every bond portfolio will see the same custom valuation discount**. The discount depends on what kinds of bonds are held in the portfolio. Bonds that do not trade very often, bonds with complex features (for example, call provisions, put provisions, sinking funds, etc.), older bonds, bonds with longer maturities, and bonds with lower credit ratings tend to exhibit larger custom valuation discounts.

Somewhat counter-intuitively, bonds with very high prices and bonds with very low prices both tend to exhibit larger custom valuation discounts than bonds priced near the par value. Bonds with very high prices tend to benefit from incorporating prices after the valuation date to capture the downward price trends. In general, higher priced bonds exhibit steeper the price trends, which translate into larger custom valuation discounts.

Bonds with very low prices tend to benefit from the fact that markdowns, expressed as a percentage of the price, tend to be higher than markdowns on par bonds. For example, consider an investor holding one investment grade bond with a prevailing market price of \$101 in a market where dealers are offering institutional markdowns of \$1 and retail markdowns of \$3. A custom valuation of this bond would yield a discount of 2 percent, reflecting the fact that a standard bond valuation would calculate a fair market value of \$100 (\$101 minus \$1 institutional markdown) and a custom bond valuation would calculate an FMV of \$98 (\$101 minus \$3 retail markdown).

Now, consider a second investor whose total bond holdings are roughly the same dollar amount as the

first investor, but this investor holds two non-investment (“high-yield” or “junk”) bonds, each with a prevailing market price of \$50.50. If the dealer markdowns on these bonds were \$0.50 and \$2.50 for institutional and retail customers, respectively, the custom valuation of this two-bond portfolio would yield a discount of 4 percent. This discount reflects the fact that a standard bond valuation would calculate a fair market value of \$50 (\$50.50 minus \$0.50 institutional markdown) and a custom bond valuation would calculate an FMV of \$48 (\$50.50 minus \$2.50 retail markdown).

Nelson writes:

It was not easy finding an appraiser that had the experience and credentials to address the dilemma we faced. I wrote to a number of excellent lawyers but none had knowingly experienced the problem. Their typical suggestion was to contact a business appraiser. It’s possible professionals and clients are unaware of the possibility that their bond portfolios may be overvalued by stan-

dardized valuation services.

It may be beneficial for attorneys administering estates with large bond portfolios to obtain an appraisal from a standard bond valuation service and simultaneously sell a number of bonds to determine whether their experience is similar to ours. If it is and if the estate’s bond portfolio is valued at \$1.2 million (an amount where the tax savings from a 2 percent custom valuation discount at a 45 percent estate tax rate exceeds a \$10,000 cost) or more, they might consider getting a custom appraisal. As we’ve learned, appraisals are only as good as the data used in the analysis as well as the assumptions and expertise of the appraiser.

We are treading in new waters and it’s likely that the IRS will question any custom bond appraisal. Then, of course, it’ll be the responsibility of the professionals to substantiate why values are less than those provided by standard bond valuation services. Of course, the ultimate decision on whether to proceed with this process may be based upon the client’s risk tolerance. **TE**

Custom Trumps Standard

Custom valuation discounts, depending on the size of the portfolio, can mean big estate tax savings

It’s typical to see custom valuations that are 1, 2 and 5 percent less than standard bond valuations—producing nice estate tax savings for clients with large bond portfolios.

When standard bond valuations are . . .			
	\$2 million	\$5 million	\$10 million
<i>custom bond valuations typically discount by . . .</i>			
<i>lessening the valuation by . . .</i>			
5%	\$100,000	\$250,000	\$500,000
2	40,000	100,000	200,000
1	20,000	50,000	100,000
<i>producing estate tax savings of . . .</i>			
5%	\$45,000	\$112,000	\$225,000
2	18,000	45,000	90,000
1	9,000	22,500	45,000

— Barry A. Nelson and Michael S. Piowar

Endnotes

1. See Internal Revenue Service, Instructions for Form 706 (Revised September 2007), p. 13.
2. The valuation date is generally the date of death of the decedent. Internal Revenue Code Section 20.2032-1 provides for an alternate valuation date.
3. See, for example, Lawrence Harris and Michael Piowar, “Secondary Trading Costs in the Municipal Bond Market,” *Journal of Finance*, June 2006, at pp. 1361-1397, and Amy Edwards, Lawrence Harris, and Michael Piowar, “Corporate Bond Market Transaction Costs and Transparency,” *Journal of Finance*, June 2007, at pp. 1421-1450.
4. www.ftinteractivedata.com/07products/data_type/evaluated/index.shtml.
5. Bond dealers are required to report all transactions in municipal bonds to the Municipal Securities Rulemaking Board’s (MSRB’s) Real-Time Transaction Reporting System (RTTRS). Similarly, bond dealers are required to report corporate bond trades to the Financial Industry Regulatory Authority’s (FINRA’s, formerly known as NASD’s) Transaction Reporting and Compliance Engine (TRACE) system.
6. \$433 tax savings = (40 x 100) x (\$105.13 - \$107.54) x 45 percent.
7. \$1,340 tax savings = (20 x 100) x (\$118.25 - \$133.14) x 45 percent.

CUSTOM BOND VALUATIONS DON'T (NECESSARILY) SAVE MONEY

*The playing field between institutional and individual investors is being leveled.
The result: standard valuations are fairly accurate*

By Kristopher M. Burak

The belief that estates can realize significant estate tax savings from custom bond valuations is based largely on the inefficiencies of the fixed income markets and the use of standard bond valuations. There's some validity in that belief, but nowadays, the discrepancy between the prices that institutions and individuals receive for bonds should not be that great. Standard bond valuations shouldn't be that "off" from custom bond valuations and shouldn't produce significant estate tax savings.

During the past five years, giant strides have been made to create transparency and efficiency in the bond markets. The biggest step forward is that all corporate and municipal trades must be reported to their regulating authority in a timely fashion. For municipal bonds trading in the secondary market, trades are reported to the Municipal Securities Rulemaking Board (MSRB). For corporate bonds trading in the secondary market, trades are reported to the Financial Industry Regulatory Authority (FINRA). All trading information is available through the Internet and can be viewed at www.investinginbonds.com. This website is published by the Securities Industry and Financial Markets Association (SIFMA) in an effort to educate investors. The site is user-friendly and informative, showing all transactions in the municipal and corporate markets.

These efforts have made the fixed-income market more efficient. As transaction information now is available to all, the playing field between retail investors and institutional investors is leveling. Retail investors, armed with more knowledge, can receive better execution through lower mark-ups

and mark-downs. Also, there are multiple brokerage houses specializing in fixed income that can negotiate on their behalf. The result is that the spreads are not as wide as they once were. For example, let's say the institutional market is \$100 bid and \$101 offer. A retail investor may be paid \$98 for its retail-size position for a block of 25 million (\$25,000 face value). A bond valuation based on the institutional price would calculate a fair market value (FMV) of \$100, while a custom valuation would calculate an FMV of \$98. But, with the help of a bond specialist or by accessing information available to the investor, a better execution price is possible.

Still, I disagree that if the retail investor was paid \$98, a custom bond valuation should be \$98. The dealer, in turn, sells the position to another investor at the offer side. In my opinion, the end user should be included as part of the transaction and the calculation of the FMV. The true value of the security is where it can be bought and sold—it's not based solely on the bid side of the market.

Standard bond valuations typically are used from pricing services and not based on transactions. Custom bond valuations performed by economic experts should take into consideration the security, or like security, if it is infrequently traded. But, if investors use the tools available to them, they can get better execution when selling (and buying) the securities.

Of course, investors also might generate estate tax savings by having a custom bond valuation—it just might be that the savings are not significant. **TE**

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