Ludwick v. Commissioner, T.C. Memo. 2010-104
(May 10, 2010)

Undivided Interest Discount in Real Estate Determined Taking Into Consideration Illiquidity and Marketability Factors in Addition to Just Cost of Partition

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Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Synopsis

Fifty percent undivided interests in a Hawaiian vacation home transferred by spouses to their separate QPRTs were valued for gift tax purposes. The judge asked each appraiser why there should be any discount beyond just the cost of partition. Both experts convinced the judge that additional adjustments should be allowed for marketability or illiquidity risks of being unable to sell the house quickly at its fair market value. The judge determined the value assuming a two-year partition action would be required (resulting in a 26.5% discount) and assuming that the property could be sold in one year without a partition action (resulting in a 16.2% discount). The judge weighted those outcomes, concluding that there was a 90% likelihood that no partition action would be needed. The resulting weighted discount was about 17.2%.

The general approach in this case is not startling, in that the court did recognize (apparently after having been convinced by both experts), that the discount should be something more than just the cost of partition in order to reflect liquidity or marketability risks. A critical factor in determining the amount of the valuation adjustment is what discount factor to apply in discounting the presumed sale proceeds from the assumed date of an eventual sale to present value. The IRS's expert said to use a 10% discount factor, and the taxpayer's expert purportedly said to use a 30% discount factor. The court used the 10% factor, based largely on the taxpayer's burden of proof.

Basic Facts

Husband and wife each transferred an undivided 50% interest in a Hawaiian vacation home to their separate QPRTs. The issue is how much discount is available for determining the gift tax value of the transfers to the QPRTs. Although not mentioned in the opinion, apparently there was a Tenancy in Common Agreement that (1) removed the right of a co-tenant to partition, but (2) gave each co-tenant the right to sell his or her undivided interest to the other co-tenant at a pro-rata value of the whole, or, alternatively, to sell the property in its entirety. (The Tenancy in Common Agreement is discussed below.)

On the gift tax returns, the taxpayers applied a 30% undivided interest discount. The IRS deficiency allowed a discount of only 15% and the IRS's brief argued for a discount of no more than 11%.

Holdings

The opinion (decided by Judge Halpern) allowed a 17.2% discount. The court analyzed (1) the present value of sale proceeds, less expenses, if the property were sold in two years in a partition action, (2) the present value of sale proceeds, less expenses, if the property were sold in one year without the necessity of a partition action, and (3) applied a weighting factor of a 90% likelihood that the property would be sold within one year without a partition action.

Analysis and Discussion

(1) Background. The IRS for many years took the position that the only discount available for valuing undivided interests in real estate is the cost of partition. TAM 9336002. A number of cases have rejected that approach, taking the position that the cost of a partition action is merely one of the factors to consider. E.g., Samuel J. LeFrak v. Commissioner, T.C. Memo. 1993-526 (20% minority discount and 10% marketability discount for gifts of undivided 10% interest in apartment and office buildings; statement that in addition to the cost of partition, the court must consider "uncertainty, and delays attendant upon partition proceedings"); Estate of Ellie Williams, T.C. Memo 1998-59 (IRS offered no expert testimony but just relied on taxpayer's burden of proof; court rejected mere cost of partition approach because that does not address lack of control and marketability issues; discounted 20% for lack of marketability and additional 30% of the remaining 80% value for lack of control and the need to bring a partition proceeding to realize value; court noted that the absence of sales of fractional interests evidenced a lack of marketability); Estate of Baird, T.C. Memo. 2001-258 (60% undivided interest discount for timberland). Interestingly, the Fifth Circuit determined that the estate in Baird was entitled to an award of administrative and litigation costs because the IRS was not substantially justified in taking the position that the only discount allowable when valuing fractional undivided interests in timberland was the cost of partitioning the property. Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005), rev'g, T.C. Memo 2002-299.

(2) Rejection of Both Experts' Approaches. As so often happens in Tax Court cases, the court largely rejected all of the approaches offered by both experts. Various data and studies were rejected as not being specific enough or not giving the court enough detail to determine their applicability to the vacation home under consideration.

(3) Two-Pronged Approach; Cost of Partition and Sale Cost if Partition Unnecessary. The court asked both experts "why a buyer of an undivided interest in the property would consider the interest worth any less than a proportional share of the fair market value of the whole property reduced by the cost to the buyer of partition…." Both experts convinced the court "that a buyer would also take into account marketability or liquidity risk; i.e., 'the risk of being unable to sell an asset quickly at its fair market value.'…They disagreed, however, as to the size of the appropriate discount and as to whether partition would even be necessary."

If a partition were necessary, the court's approach was first to assume that the partition action would take two years to be resolved. In that scenario, the court applied 1% litigation costs, 6% selling costs, an annual operating cost of $350,000, a growth rate of 3% and a discount rate for the present value calculation of 10% (rejecting the taxpayer's expert's estimate of 30% discount based on the taxpayer not satisfying the burden of proof). (However, the taxpayer's appraiser has informally indicated that the opinion is not totally clear on this point and that he did not use a 30% discount-to-present value factor.) The calculation resulted in a 26.5% discount.

If a partition were not necessary, the court assumed that the sale could occur within one year (resulting in a significantly higher present value without the additional one year of the present value discount factor) and the litigation cost would be avoided. The non-contested sale approach discount was 16.2 percent.

The court then weighted those two approaches, finding it unlikely that a partition action would be necessary (partly in reliance on the taxpayer having the burden of proof), and gave the contested partition approach only a 10% weighting. The overall weighted discount (90% weighting to 16.2% discount and 10% weighting to 26.5% discount) was about 17.2 %.

(4) Significance. The general approach in this case is not startling, in that the court did recognize (apparently after having been convinced by both experts), that the discount should be something more than just the cost of partition in order to reflect liquidity or marketability risks. The issue is how to quantify the additional risks.

The key significant items of general application from this analysis are (1) analyzing the effects of a partition sale and a sale without a court partition and giving a very high weighting (on the facts of this case) to the assumption that the sale would be made without a court partition, and (2) applying a relatively low discount factor (i.e., the assumed return that an investor would demand for this type of property) (10%).

(5) Unclear How Much of Decision Was Based on Tenant in Common Agreement. Very interestingly, there was a Tenancy in Common Agreement, not even mentioned in the court opinion, that (1) removed the right of a co-tenant to partition, but (2) gave each co-tenant the right to sell its undivided interest to the other co-tenant at a pro-rata value of the whole, or, alternatively, to sell the property in its entirety. That agreement is not mentioned in the court opinion, but is summarized in a summary of this case by the taxpayer's expert, Mr. Carsten Hoffman. Hoffman, TAM 9336002 bites Taxpayer, FMV VALUATION ALERT (May 12, 2010). This unusual provision in the TIC Agreement seems highly relevant. It is easy to understand that one would assume that there would be no necessity of a formal litigated partition proceeding if either co-tenant had the absolute right to sell the property in its entirety. The failure to mention this agreement in the analysis leads Mr. Hoffman to conclude that after reading the opinion a number of times, it remains unclear to him "whether the result of focusing on the relatively minor costs associated with an uncontested sale of the property is a consequence of the TIC Agreement, or the consequence of a new line of thinking put forth by Judge Halpern for any undivided interest valuation where a co-tenant retains the right to force a

partition." As a planning pointer, Mr. Hoffman suggests that "[a]lthough much can be said about the shortcomings of a partition approach, one sure way to avoid the argument is to have an iron-clad waiver of the right to partition." (The IRS might conceivably then argue that the agreement to waive the right to partition must be ignored for valuation purposes under §2703; the IRS did not make a §2703 argument in this case.)

(6) Application of Analysis to Other Undivided Interest Situations. This case resulted in a significant discount (about 17.2%), partly because there were substantial operating expenses ($350,000 per year). In other situations, where the annual operating expenses are much lower, the discount may be much lower as well. Critical factors in the discount analysis are a determination of (1) how long a sale, either by a partition action or otherwise, will take, and (2) the appropriate discount rate for discounting the ultimate sale proceeds to present value. This latter factor is generally the return that investors would require for investing in this type of real estate, and seems to vary widely. In this case, the IRS's expert used a 10% discount factor and the taxpayer's expert used a 30% discount factor. (As indicated above, however, the taxpayer's appraiser has informally indicated that the opinion is not totally clear on this point and that he did not use a 30% discount-to-present value factor.) In any event, it seems likely that an investor in a large Hawaiian residence would want more than an anticipated 10% rate of return, or else the investor would not be interested in investing in the property. The "discount-to-present value" factor obviously greatly impacts the overall valuation discount if the anticipated sale date is a year or two (or more). In this case, the court used the lower 10% factor, apparently based on the taxpayer's burden of proof. ("Petitioners have failed to prove that a buyer would demand a return greater than 10 percent.")

(7) Comparison to Other Undivided Interest Discount Cases. The 17.2% discount allowed by the court is not out of line with the general range of overall undivided interest discounts that have been allowed by other courts. The following is a brief overview of some of the cases over the last 20 years that have addressed valuation discounts for undivided interests in real estate.

A 1993 case allowed a 20% minority discount and a 10% marketability discount for gifts to children of interests (under 10% to each child) in a number of apartment and office buildings. Samuel J. LeFrak v. Commissioner, T.C. Memo. 1993-526. (For the Field Service Advice on this case, see FSA 1999-844, which concluded that Revenue Ruling 93-12 does not require that a minority discount be allowed in valuing intra-family gifts of undivided interests in real property.) In LeFrak, the court noted that the cost of partition is only one of three factors to consider, and that "uncertainty, and delays attendant upon partition proceedings" must also be considered.

A 1997 case effectively allowed a 26% discount in valuing a 25% undivided interest in timberland. Estate of Barge v. Comm'r, T.C. Memo 1997-188 (analysis based on cost and time for partition to occur, taking into account the anticipated annual income from the property, applying a 10% capitalization rate and determining the present value of the receipt of a parcel of land equivalent to the fractional interest at a time four years in the future).

A 1998 case allowed a 44% discount for an undivided interest in timberland. Estate of Ellie Williams, T.C. Memo 1998-59 (IRS offered no expert testimony but just relied on taxpayer's burden of proof; court discounted 20% for lack of marketability and additional 30% of the remaining 80% value for lack of control and the need to bring a partition proceeding to realize value; court noted that the absence of sales of fractional interests evidenced a lack of marketability).

A 1999 case agreed with the taxpayer's expert in allowing a 20 percent discount in valuing the decedent's 50 percent interest in various multiple dwelling properties. The IRS's expert looked at the cost of partition to determine the fractional discount, but the case concluded that courts consider other factors, such as the historical difficulty in selling fractional interests and lack of control. Estate of Brocato v. Comm'r, T.C. Memo. 1999-424. While not mentioned in the case, an expert witness for the estate was an attorney who had litigated a partition case through the California court of appeals. He reportedly testified that the litigation cost of a partition proceeding would be $180,000 (compared to the government's witness to opined that the cost would be $20,000 per property) and that the local court procedures would likely prevent a partition case from being tried within two years. He also presented evidence that partition sales do not provide the highest and best price, but result in a forced-sales price that is less than a free-market transaction. Schiller, Taxpayer Establishes Blockage and Fractional Interest Discounts Through Market Data, 29 Tax Mangt. Est., Gifts & Tr. J. 106 (March 2000).

A 2000 case allowed a mere 10% fractional discount in valuing decedent's one-half interest in unimproved property that was appropriate for residential subdivision. The estate's expert applied a 40% discount. The court concluded that a 10% discount was appropriate because (1) there were no owners or potential owners who, like the decedent, were solely interested in farming the land, and (2) a 10% discount would be more than adequate to accommodate reasonable costs of partition. Estate of Busch v. Comm'r, T.C. Memo 2000-3. Another 2000 estate tax case allowed only a 10% discount. Reichardt Estate v. Comm'r, 114 T.C. 144 (2000).

Other cases in 2000 allowed discounts greater than the 10% allowed in Busch and Reichardt. Wineman v. Comm'r, TCM 2000-193 (15%); Stevens v. Comm'r, TCM 2000-53 (25%; "we do not limit the discount to the costs of partitioning because such a discount does not account for the factors of control and marketability"); Shepherd v. Comm'r, 115 T.C. 376 (2000)(15%, gift tax case).

A 2001 case allowed a 30% discount suggested by the estate's appraiser, based on various factors listed by the appraiser as follows: (1) the interests were minority interests; (2) the market for such undivided interests would be restricted taking into consideration the limited pool of potential buyers, the likely difficulty of securing financing and the likely costs of partitioning the two separate parcels; (3) the appraiser could not locate comparable sales, but real estate brokers in the area applied fractional interest discounts of 10% to 30% in liquidating partnerships; (4) specific characteristics of the property; and (5) possible intra-family conflicts. Estate of Forbes, 81 T.C.M. 1399 (2001).

Another 2001 case allowed a 60% undivided interest discount for timberland. Estate of Baird, T.C. Memo. 2001-258. Husband owned a 14/65 interest and wife owned a 17/65 interest in the timber. These interests, along with the remaining 34/65 interests in the timberland, had been conveyed to a trust to keep the land in undivided ownership. At husband's death, a 25% fractionalization discount was claimed, and at wife's subsequent death, a 50% discount was claimed on the estate tax returns. Later, both estates sought refunds, claiming a 60% discount. The court agreed with the 60% discount based on a variety of factors. The court found that the estate established 55% as a "mean and/or average" amount of discounts for Louisiana timberland interests that do not result in control. In addition, the court observed that the family owners had experienced prior disagreements over the land, one family member had been allowed to manage the land independently, and his management was poor. The property was placed in trust to keep the property in the family. A knowledgeable buyer would be influenced by these factors, and would perceive that the remaining family members would be resistant to and make it difficult for an outside buyer.

The Baird case is most interesting in light of the Fifth Circuit's recent determination that the estate was entitled to an award of administrative and litigation costs because the IRS was not substantially justified in taking the position that the only discount allowable when valuing fractional undivided interests in timberland was the cost of partitioning the property. Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005), rev'g, T.C. Memo 2002-299. (Interestingly, after the Tax Court awarded attorneys fees to an estate because of the IRS's continued attacks on family partnerships under a lack of economic substance argument in Estate of Dailey v. Comm'r, T.C. Memo 2002-301, the IRS stopped making that argument [and revised its position in pending cases to drop the argument].)

Historically, a variety of cases have allowed fractional interest discounts for real estate interests in the range of approximately 15-

20% (but with some outliers both below and above that general range). E.g., Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982) (15% discount); Estate of Alto B. Cervin, 68 T.C.M. 1115 (1994) (20% discount for decedent's 50% undivided interest in homestead and farm properties that passed to decedent's children who owned the remaining 50% interest); Estate of Eleanor O. Pillsbury, T.C. Memo. 1992-425 (15% discount); Estate of Harriet L. Feuchter, T.C. Memo. 1992-97 (15% discount); Zabel v. Comm'r, T.C. Memo. 1990-55 (10%); Estate of John B. Baggett, 62 T.C.M. 333 (1991) (35% discount); Nancy Mooneyham v. Commissioner, T.C. Memo. 1991-178 (15% discount for undivided one-half interest); Wildman v. Comm'r, T.C.M. 1989-667 (15%); Estate of Ila Jean Anderson, T.C. Memo. 1988-423 (20% for decedent's undivided one-half community property interest in real estate); Van Loben Sels v. Comm'r, TCM 1986-501 (60%); see Estate of McCormick, 70 T.C.M. 318 (1995) (20-22% lack of marketability discounts and 18-32% minority interest discounts for minority interests in general partnerships that own undivided interests in real property). However, this is a factual determination and cases have not always allowed discounts. E.g., Estate of Fratini v. Comm'r, T.C. Memo. 1998-308 (0% in estate tax case); Estate of Maria Iacono, T.C. Memo. 1980-520 (no discount allowed because estate failed to show that interests would sell for less than their proportionate shares of the values of the entire properties).

(8) Description of Reasoning That Undercuts Valuation Discounts Generally. Judge Halpern in Holman v. Commissioner, limited the marketability discount for gifts of limited partnership interests, in part under the reasoning that if a partner wished to transfer his or her interest, the remaining partners would always have an incentive to negotiate with the seller to pay something between what the third party was willing to pay and full pro rata entity value. His rationale is perhaps clarified by his explanation in Ludwick of an iterative process that would drive discounts down close to the cost of partition:

> "Certainly a tenancy in common is not the ideal way for two strangers to own a vacation home. That does not mean, however, that a buyer would discount an undivided interest by any more than the cost of liquidating his investment and an additional amount to reflect the risk occasioned by a less than immediate sale.
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> [The taxpayer's expert testified that if there is a right to force a partition, an 80% discount would not be reasonable "because you can partition it for significantly less than that, so why would you demand an 80 percent discount."]
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> The logic of that statement is that a buyer who had a right to partition could not demand a discount greater than (1) the discount reflecting the cost and likelihood of partition and (2)

> the discount representing the marketability risk because, if he did, another (rational) buyer would be willing to bid more. That iterative process would drive the discount down to the discount reflecting the expected cost of partition and the marketability risk."

Under that same reasoning and under the logic of Judge Halpern in Holman, would a hypothetical willing buyer on the street of an interest in an entity be willing to pay just slightly less than full pro rata entity value for an interest in an entity because he would know that if he wanted to sell the interest, the remaining partners would have an economic incentive to buy out the interest at almost any price less than full pro rata entity value? If so, that might seem to undercut valuation discounts generally (despite empirical evidence suggesting that there are substantial valuation adjustments in real life purchases of interests in closely-held assets).