TAX COURT APPLYING FRACTIONAL INTEREST TO HAWAII REAL ESTATE. CASE AT PG. 15.

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TAX COURT DID NOT AGREE WITH EITHER "EXPERT" OPINION. JUDGE MADE HIS OWN DISCOUNT OPINION FOR FRACTIONAL REAL ESTATE INTEREST - IN HAWAII.

Fractional Interest Discounts: Not If, But How Much - Articles

ALL CONTENT

Fractional Interest Discounts: Not If, But How Much

Posted by: Dan Holbrook on Jul 21, 2010

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True or False? If Husband and Wife own real property as equal tenants in common, each spouse's undivided one-half interest is valued for gift and estate tax purposes at less than 50 percent of the whole.

Answer: True. And *Ludwick*,[1] an important recent Tax Court case, proves it.

Why does this matter? The "Achilles heel" of the transfer tax system is that it is not a tax on property, but a tax on the privilege of transferring property. When Husband and Wife transfer fractional interests to children, either under their wills or by lifetime gifts, the specific interests being transferred must be valued to reflect the inherent bundle of rights and limitations of that particular partial interest, largely independent of what such transferred interest is worth in the hands of either the transferor or the transferee. When the interest being transferred is less than a fee simple interest, the limitations of partial ownership typically outweigh any benefits of partial ownership, depressing the value. The reduction in value thus created by fractionalizing ownership is often misleadingly referred to as a "discount" but instead just reflects our free market system at work.[2]

Example: Husband and Wife have estates subject to both Tennessee and federal transfer taxes at a combined rate of 50 percent. One of their assets is Blackacre, worth $1 million. They convert their tenancy by the entirety ownership in Blackacre to equal tenancy in common. As a result, when they transfer Blackacre to their children (one-half by each spouse), if the discount is 15 percent, then Blackacre will be valued for transfer tax purposes at only $850,000, and the $150,000 combined discount saves $75,000 in transfer taxes.

Why the discount? Here are some of the burdens created by fractionalizing ownership:

1. All owners have equal rights of use and occupancy, so multiple owners may encounter friction on how to exercise those rights.
2. All decisions on use, repairs, financing, sale, etc., require unanimity, so agreement is never assured and lack of control can be frustrating.
3. Using the property as collateral for borrowing is more difficult because banks may not accept a partial interest as collateral.
4. Each owner has unlimited liability for the acts of all other owners with respect to the property.
5. There is usually little or no market for fractional interests, making a partial interest more illiquid than full ownership.[3]

How large should the discount be? A representative sample of cases is outlined in the chart below.

A Representative Sample of Cases

Case	Discount	Year

Propstra[4]	15 percent	1982 (Establishing the Propstra 15 percent "safe harbor")
Sels[5]	60 percent	1986
Youle[6]	12.5 percent	1989
Feuchter[7]	15 percent	1992
LeFrak[8]	30 percent	1993
Cervin[9]	20 percent	1994
Barge[10]	26 percent	1997
Williams[11]	44 percent	1998
Brocato[12]	20 percent	1999
Busch[13]	10 percent	2000
Stevens[14]	25 percent	2000
Forbes[15]	30 percent	2001
Baird[16]	60 percent	2001

Why such a wide range of discounts? Widely varying facts. The lowest discounts typically involve poorly substantiated appraisals, and the highest discounts typically involve unimproved, non-income-producing property, highly illiquid, where a purchaser's return on investment and time frame to realize such return are necessarily speculative.

Do discounts obtain even if no one outside of the family is likely ever to own an interest? Has an IRS argument for "family attribution" totally failed? Can spouses simply divide ownership of an asset and (Abracadabra!) make value disappear, lowering gift and estate taxes? Perhaps surprisingly to anyone but tax lawyers, the answer to all these questions is a resounding yes.[17] The recent *Ludwick* case is instructive.

In *Ludwick*, each spouse gifted his or her 50-percent tenancy-in-common interest in a vacation home in Hawaii worth $7,250,000 to his or her own Qualified Personal Residence Trust (QPRT), a type of trust statutorily authorized to create gift tax advantages for transfers of residential properties. The spouses obtained an appraisal claiming a 30-percent discount on the value of each of their one-half interests. Although the terms of the QPRTs were not described in the opinion, QPRTs typically terminate after a fixed period of years and pass the residential property to children, who would have received it from their parents someday anyway. Discounts for fractional interests in such case may seem somehow out of place, since the net effect is for the residential property to pass eventually from parents to children quite intact. Before *Ludwick*, no cases existed on the valuation of fractional interest gifts to QPRTs, so *Ludwick* presented the IRS with an opportunity to use potentially weak facts with intra-family transfers to limit fractional interest discounts.

Tellingly, the auditor of the federal gift tax return did not even try to argue against the existence of some amount of discount, and initially offered to settle for a Propstra 15 percent "safe harbor" discount. When the taxpayers rejected that offer and appealed to Tax Court, standing by their 30-percent discount appraisal, the IRS obtained its own appraiser, who set the discount at 11 percent. Tax Court Judge Halpern recognized both appraisers as experts on appraising fractional interests, but strongly criticized both appraisals, mostly for relying on insufficiently apposite comparable sales, and did his own analysis, finding a 17-percent discount.[18]

Thus while the appropriateness of discounts is well established, courts and tax auditors are increasingly stressing the quality of appraisals in determining the size of the discount. Appraisers should carefully address the many issues that affect the value of a fractional interest and persuasively substantiate any claimed discount, especially if the discount exceeds 15 percent.

As lawyers, we can assist clients not only by helping them find informed appraisers,[19] but also, in some cases, by educating appraisers on the latest cases, so that the appraisals are more likely to stand up on audit.[20] However, there is a fine line between a helpful review that improves the appraisal's thoroughness and persuasiveness and heavy-handed participation that may compromise the appraiser's independence. The former is not only ethical, but perhaps even our duty, while the latter is not. Ultimately, as captains of the estate planning team, estate lawyers should be diligent in helping clients obtain and substantiate the discounted values allowed by law.

Notes

1. *Andrew K. Ludwick and Worth Z. Ludwick v. Commissioner,* T.C. Memo 2010-104 (filed May 10, 2010).
2. The same principle applies to an interest in a corporation, partnership, or limited liability company. State law provides the legal benefits and burdens of ownership of an interest in the entity, often causing such an interest to have a value for gift and estate tax purposes that is less than the corresponding percentage of the entity's underlying assets.

3. Can't a partial owner file a partition lawsuit to create liquidity? Certainly, but that will cost time and money, which basically confirms that some discount is always appropriate. The IRS in PLR 9336002 stressed the costs and delays of partition suits as perhaps the most important (or only) factor in determining how much discount is appropriate. But courts have been more far-reaching in analyzing multiple factors that cause discounts on fractional interests, and the IRS backed off of its untenable position in PLR 9994003, recognizing multiple approaches to value.
4. *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982).
5. *Estate of Della Walker Van Loben Sels v. Comm'r,* T.C. Memo 1986-501 (1986).
6. *Estate of George W. Youle v. Comm'r,* T.C. Memo 1989-138 (1989).
7. *Estate of Harriett L. Feuchter v. Comm'r,* T.C. Memo 1992-97 (1992).
8. *Samuel J. LeFrak v. Comm'r*, T.C. Memo 1993-526 (1993).
9. *Estate of Cervin v. Comm'r,* T.C. Memo 1994-550(1994).
10. *Estate of Bonnie I. Barge v. Comm'r*, T.C. Memo 1997-188 (1997).
11. *Estate of Williams v. Comm'r*, T.C. Memo 1998-59 (1998).
12. *Estate of Eileen K. Brocato v. Comm'r*, T.C. Memo 1999-424 (1999).
13. *Estate of Busch v. Comm'r*, T.C. Memo 2000-3 (2000).
14. *Estate of Eileen Kerr Stevens v. Comm'r,* T.C. Memo 2000-53 (2000).
15. *Estate of August P. Forbes v. Comm'r,* T.C. Memo 2001-72 (2001).
16. *Estate of John L. Baird v. Comm'r,* T.C. Memo 2001-258 (2001).
17. Of course, discounts for fractional interests are not limited to interests owned by spouses. Nor are fractional interest discounts limited to real property. In one case, the author divided the ownership of a diamond valued at $1 million by advising mother, who owned the diamond, to give her daughter a 1-percent interest by bill of sale. At mother's death, the asset in her estate will be not the diamond but only a 99-percent interest in the diamond, which is expected to appraise for estate tax purposes with some significant discount.
18. The author recently handled a Tennessee gift tax audit where clients husband and wife had each created a QPRT funded with his or her one-half undivided interest in a residence, on which an appraiser had taken a 30-percent fractional interest discount. The Tennessee Department of Revenue agent claimed that no discount was possible, since the married couple owned the entire property, and their children would ultimately receive the entire property. After the agent was provided a copy of *Ludwick*, the agent's supervisor agreed to the gift tax return as filed, with no change.
19. Some real estate appraisers understand how to value a fractional interest properly, but too many do not. An alternative is first to obtain a real estate appraisal for the whole property, then obtain a second appraisal by a qualified business appraiser to calculate the appropriate discount. In a recent email survey of Tennessee Fellows of the American College of Trust and Estate Counsel (ACTEC), respondents said they had obtained appraisals both ways, and the overall costs were not significantly different. Their collective preference was to get one appraisal from a real estate appraiser whenever possible, but to be cautious in selecting such an appraiser to ensure their familiarity with the law and the characteristics of fractional interest discounts.
20. For a guide to evaluating appraisals, see the Estate Planner's Manual for Evaluating Appraisals and Appraisers (March 2005), prepared by the Business Planning Committee of the American College of Trust and Estate Counsel (ACTEC). It is generally available only to Fellows of ACTEC. See www.actec.org to locate a Fellow near you.

Dan W. Holbrook

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FCG VALUATION CASE E-FLASH

Authored by Fawntel Romero, AM and Chris D. Treharne, ASA, MCBA, BVAL of Gibraltar Business Appraisals, Inc., a member firm of FCG

Issue 12:6

CITATION:
Andrew K. Ludwick, Petitioner v. Commissioner of Internal Revenue, Respondent, and Worth Z. Ludwick, Petitioner v. Commissioner of Internal Revenue, Respondent
T.C. Memo 2010-104, Docket Nos. 3281-08, 3282-08 Filed May 10, 2010.

TAKEAWAY:
In the absence of a legal obligation to the contrary, unanimity among TIC owners is required for decision making. Hence, even a large majority ownership interest cannot unilaterally implement actions on behalf of the owners. Conversely, a small, fractional interest can block decisions, which gives it authority that many other minority ownership interests do not have. In addition to addressing lack of marketability issues, analysts valuing TIC interests should consider the economic impact associated with an owners inability to control decision making.

OVERVIEW:
Regarding the value of two 50 percent tenant-in-common ("TIC") real estate interests contributed separately by husband and wife to a qualified personal residence trust ("QPRT"), the Tax Court did not find the analyses of the Taxpayers' or IRS experts convincing. Instead, the court valued the undivided half-interests using its own procedures.

THE FACTS:
Andrew K. Ludwick and Worth Z. Ludwick ("Taxpayers") owned a vacation home in Hawaii as tenants in common, each having an undivided one-half interest.

Hawaii law (Haw. Rev. Stat. Ann. Sec. 668-1) provides for the partitioning of real property.

In 2005, Mr. and Mrs. Ludwick each transferred their individual undivided interests to separate QPRTs. At the time of the transfers, the property had a market value of $7.25 million and an annual operating cost of approximately $350,000.

On their separate 2005 federal gift tax returns, Mr. and Mrs. Ludwick each reported a gift resulting from the transfers of the undivided interests to the trusts. The undivided one-half interest in the property was valued at a discount of 30 percent.

The IRS determined a discount of 15 percent. On brief, the IRS argued for a discount no greater than 11 percent.

DISCUSSION:
The Taxpayers' expert was recognized as an expert in valuing undivided interests. His analyses considered the sale of undivided real estate and partnership interests.

More specifically, the Taxpayers' expert considered 69 transactions of undivided interests that occurred between 1961 and 2006. He considered three subsets of properties (income-producing, parcels of raw land, and transactions involving 50 percent undivided interests). However, he only provided limited data to the Tax Court, and it was unable to more thoroughly evaluate his analysis.

Additionally, the Taxpayers' expert compared the subject undivided interests to transactions in ten real estate limited partnerships owning apartment complexes and mobile homes. The Tax Court criticized his analysis because - unlike the real estate partnerships' properties - the subject property was never intended to produce income.

The IRS' expert was also recognized as an expert in valuing undivided interests. His analyses relied on:

- the sale of undivided interests,
- various surveys of real estate brokers,
- a review of tender offers for majority interests in public companies, and
- a lawyer's estimate of the cost of partition.

First, the IRS expert relied on four sales of undivided interests in commercial properties located in the eastern United States that occurred between 2002 and 2007. However, the Tax Court concluded that this data reveals very little about an appropriate discount for a multimillion dollar vacation home located in Hawaii.

Additionally, the real estate broker surveys conducted by the IRS expert provided very little information to the Tax Court, which had no way of adequately evaluating the survey's responses. Further, the court recognized, "the brief explanations are often so cryptic as to reveal almost nothing about the reasons behind the discount ranges."

Lastly, the IRS expert also considered tender offers for majority interests in public companies. The transactions involved the change of control of real estate companies. He noted that the control premium depends on various factors including "the buyer's desire or need to acquire the company... to compliment his present operation". The Tax Court found such factors irrelevant.

The Court's Analysis

The Tax Court asked both experts why a buyer would pay less than a proportionate share of the market value of the property reduced by the cost to the buyer to partition the property. Both experts convinced the court that a buyer would consider marketability or liquidity risk. However, the experts disagreed as to the size of the appropriate discount and whether a partition would be necessary.

The Tax Court concluded that a buyer would be willing to pay an amount equal to the present value of the proportionate share of the market value of the property less the costs of maintaining and selling the property.

However, the Taxpayers failed to convince the court that a partition will always be necessary; so the court found that a partition would be necessary 10 percent of the time. As a result, the court determined the value the interests using its own weighted approach of 1) the cost to sell the property if a partition is not necessary and 2) the cost to sell the property if a partition is necessary. The sale proceeds, operating costs, and selling costs were determined as follows:

- A contested partition would take two years to resolve.
- Litigation costs would equal 1 percent of the value of the property.
- Operating costs would equal one-half of the total operating costs.
- The IRS expert testified a buyer would demand a return of 10 percent. In contrast, the Taxpayers' expert testified that a buyer would demand a return of 30 percent but failed to present evidence to support his conclusion. The court used a 10 percent discount rate.
- The court's estimate of the market value of the property at the time of sale based on the Taxpayers-expert's testimony that the "long-term sustainable growth [rate] of real estate" was 3 percent annually.

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Judicial Opinions Regarding Fractional Interests in Real Estate

This article presents an overview of several recent judicial opinions regarding appropriate discounts for fractional interests in real estate. Fractional interests in real estate result from a property owner's ownership of less than 100% of a given property. Generally, the owner of a fractional interest has the right to partition, the right to a pro rata share of income, and veto power over decisions concerning the use or disposition of the property. Ultimately, state laws determine the bundle of rights available to the owner of a fractional interest. Common sense and numerous judicial opinions tell us that a fractional interest in real property is worth less than the interest's pro rata portion of the total property value. For property owners, their advisors, and appraisers, the issue is determining what discount to the interest's pro rata portion of the fee simple property value is appropriate.

To support an appropriate discount for a fractional interest, two appraisals will likely be required. The first step is to obtain a credible real estate appraisal for the underlying property. Because most real estate appraisers are not experienced in valuing fractional interests, the next step is hiring a valuation professional who understands valuation methodologies and how they apply to fractional interests.

IRS Position. In issuing deficiency notices, the IRS frequently attempts to limit the amount of the fractional interest discount to the cost to partition the property; however, the *IRS Training Manual for Appeals Officers Coursebook* recognizes several factors that could influence the size of the discount. The following factors are listed in the *Coursebook*:

» The size of the fractional interest;
» The number of owners;
» The size of the tract;
» The use of the land;
» Availability of financing for undivided interests; and,
» The costs of dividing the land (partition).

IN THIS ISSUE

Judicial Opinions. Generally the courts have concluded that fractional interest discounts are appropriate in determining the fair market value of a fractional interest in real estate. The table below shows several recent Tax Court Memorandums that applied fractional interest discounts based upon the facts and circumstances of the particular case. As can be seen in the sample below, a wide range of fractional interest discounts have been allowed.

TC Memo	Petitioner's Name	Fractional Interest	Fractional Interest Discount
1997-188	Barge	25% Interest in Timberland	26%
1998-59	Williams	50% Interest in Timberland	44%
1999-424	Brocato	50% Interest in Apartments	20%
2000-3	Busch	50% Interest in Residential Development Properties	10%
2000-53	Stevens	50% Interest in Commercial Property	25%
2001-72	Forbes	42% & 42.9% Interest in Two Parcels of Land	30%
2001-288	Baird	26% Interest in Timberland Held Through a Family Trust	60%
2006-76	Amlie	56% and 50% Interests in Two Parcels of Land	15%

... many judicial opinions support discounts greater than the costs of partition in determining fair market value for fractional interests in real estate based upon the facts and circumstances prevailing at the valuation date

The following discussion presents brief summaries of these recent Court decisions.

At issue in *Estate of Bonnie I. Barge v. Commissioner* was a 25% undivided interest in timberland that was gifted in 1987. The parties stipulated that the fee simple value of the timberland was $40 million at the valuation date. The Court determined that the undivided interest could be liquidated or turned into a fee interest within four years by way of an action for partition. After estimating the monetary costs and benefits over the four year period, a discounted cash flow analysis at a 10% rate found the value of the 25% fractional interest was $7,404,649.

A 1998 Tax Court decision rejected the Service's argument that a discount no larger than 5% should apply because petitioner offered no evidence of actual sales of fractional interests in real property. In *Estate of Williams v. Commissioner*, the Court held that banks generally will not lend money to the owner of a fractional interest in real property without the consent of the co-owners and that the inability to find sales of fractional interest in comparable searches shows that there was no market for fractional interests in such property.

In *Estate of Brocato v. Commissioner*, decedent owned nine apartment properties, three in which ownership was 50%. The court allowed an 11% blockage discount on seven of the properties that were similar. For the three properties in which decedent owned a 50% interest, the Court considered the size of the interest, the lack of a market for the interests, special circumstances surrounding the sale, and whether there would be a forced sale in determining the proper fractional interest discount. The Court rejected the Service's argument that the fractional interest discount should be no more than the cost to partition.

A case in which the court did not agree with either party's real estate appraisal or fractional interest discount involved a 50% interest in 90.74 acres in Alameda County, California in *Estate of Busch v. Commissioner*. Because of numerous facts and circumstances the Court determined the fee simple market value of the property and applied a 10% fractional interest discount.

In *Estate of Stevens v. Commissioner*, the Court stated, "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 in the circumstances of this case."

In the *Estate of Forbes v. Commissioner*, the Court concluded, "We are unsatisfied that any of the parties' experts have adequately justified their recommended discount rates – a shortcoming that might be attributable in part to a lack of available empirical data. Given that the parties agree that some valuation discount is appropriate, however, and lacking any firm basis on which we might independently derive one, we accept Lawton's recommended 30% valuation discount as being the most reasonably justified of the opinions presented to us."

In a 2001 case, a family trust held timberland and the decedent held a 26% interest in the trust. The IRS took the position that the only discount allowable in *Estate of Baird v. Commissioner* was the cost to partition. The Court ruled that the taxpayer's 60% claimed discount was appropriate. As a further note, the Fifth Circuit concluded that the IRS' litigation position was unjustified and reversed and remanded the Tax Court's decision not to award the estate its administrative and litigation expenses under Section 7430.

Estate of Amlie v. Commissioner is most famous for the Court's opinion on a buy/sell agreement; however, the Estate also held a 56% and a 50% fractional interest in two pieces of agricultural land. While the IRS argues that no discount is appropriate, in litigation the estate recommended discounts between 25% and 35% as appropriate. The Court held that 15% discounts were correct as "the estate has shown entitlement to a fractional interest discount no greater than that which would reduce the values of Parcels 2 and 3 to the amounts reported on the return."

Conclusion. The above table and discussion demonstrate that many judicial opinions support discounts greater than the costs of partition in determining fair market value for fractional interests in real estate based upon the facts and circumstances prevailing at the valuation date. Give us a call at 901.685.2120 if we can assist with your fractional interest appraisal.

For more information about fractional interests in real estate, visit our website to see our 1997 article "Valuing Fractional Interests in Real Estate". The Tax Court Memorandums reviewed can be found at http://ustaxcourt.gov/ under the Opinions Search tab.

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CONCLUSION:
The Tax Court did not find the analyses of either expert convincing. The court valued the undivided half-interests using its own weighted approach of 1) the cost to sell the property if a partition is not necessary, and 2) the proceeds associated with a partitioning action, recognizing a 10 percent probability of such an occurrence.

After weighting its two approaches, the Tax Court valued each undivided one-half interest at a discount of 17 percent.

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Posted: November 17, 2017

Partial interest valuation of real estate: A case study - by Marc Nadeau

Marc Nadeau, Nadeau & Associates

Partial Interest Value – The Concept

Partial interest valuation is a technique used by appraisers and other valuation professionals to estimate the value of a fractional interest in real estate. Fractional interests in real estate result from the owner's ownership of less than 100% of a given property. The technique involves the valuing of a fractional interest in real property with a discount factor being applied to that fractional interest. Reflective of what could be a number of factors including, but not limited to the nature of the property, the percentage or ownership and the management structure in place an appropriate "discount factor" is chosen by a valuation professional. Ownership of a partial interest in real property ownership can manifest itself in a number of forms. Those ownership forms include, but are not limited to: general partnerships, limited partnerships, REITs, joint tenancy, tenants in common, tenancy by entirety, family trusts and ownership of shares in a limited liability corporation.

The transfer or conveyance of a partial interest can arise from any number of events including: divorce, partnership dissolution, estate planning, donation or sale of a partial interest to an unrelated party and so on. In theory, partial interests are almost always worth less than their fractional value. For example, a $1 million dollar property owned by five different owners, each with a 20% interest, would in pure mathematical terms have a value of $200,000 for each interest. That 20% interest, were it to be marketed or sold to another party would be considered a minority interest.

The nature of a minority interest is that it typically has the following characteristics:

• Lack of marketability

• Longer than typical marketing time

• Lack of control

• Limited or no ability to refinance the property; and

• Limited ability to influence decision-making policies.

Discounts associated with a partial interest can typically range from 20% to 60% of the proportionate value of the interest as it relates to the entire property. In the case of the $200,000 fractional interest above, a discount factor would be applied to the fractional value.

The IRS perspective

The perspective or position of the IRS has frequently been that the discount applied to the fractional interest be limited to the actual cost of partitioning a property. The courts fortunately, have generally recognized that this is both unreasonable and illogical. The fact is that fractional interests for the most part have a very limited market appeal to the general marketplace with the range of appeal varying by the type of property and the percentage of ownership.

The IRS Training Manual for Appeals Officers in fact recognizes and cites several factors that could influence the size of the discount. The following factors are listed in the manual:

• The number of owners

• The size of the fractional interest

• The size of the tract

• The use of the land

• The availability of financing; and finally,

• The cost of partitioning (dividing) the land.

Valuation Methodology

The following steps would be involved in valuing a partial interest:

1. Value the property in its entirety;

2. Calculate the value of the proportionate share in the property by taking the 100% value of the property times the percentage of property owned;

3. Determine an appropriate discount for the partial interest and;

4. Calculate the value of the fractional interest by multiplying the value of the "proportionate share" times the discount rate.

Discount Rates ~ what are appropriate rates?

Reflective of the fact that partial interests have very limited marketability there is certainly a lack of empirical market data that appraiser's can draw from. One of the best benchmarks for determining an appropriate discount would be court cases.

The following is a summary of relevant court cases that involve partial interest valuations:

In the case of *Lefrak vs. Commissioner* the court did not consider fractional discounts as compelling evidence because security owners do not have the right to force partition (the shares were part of a corporate entity). However, the Court did allow a 30% discount for a minority interest and a lack of marketability.

In the case of the *Estate of Cervin vs. Commissioner* the Court allowed a 20% discount for a 50% undivided interest in a homestead and farm. The legal costs along with the time delays and discounts required by a prospective buyer were reasons for the granted discount.

The case of *Williams vs. Commissioner* involved the transfer of a 50% interest in 2,360 acres of rural land and its timber in Putnam County, Florida. The court found a discount of 44% to be reasonable. The discount factored in the cost of partitioning, the longer than typical anticipated marketing time and the lack of control.

The case of the *Estate of Baird vs. Commissioner* involved minority interests of timberland located in Louisiana. The plaintiffs specifically in this case were that of the Estate of John L. Baird and the Estate of Sarah W. Baird who were married at all pertinent times. John died on December 18, 1994 while Sarah died less than 1 year later on November 2, 1995. At times of death, John held a 14/65 interest while Sarah held a 17/65 interest in a trust that owned 16 noncontiguous tracts of timberland comprising 2,957 acres.

Both estates claimed a 60% discount on the tax returns with the plaintiffs mounting an impressive case that involved the testimony of two real estate appraisers that had extensive experience in valuing timberland as well as a third expert witness that had the experience of actually purchasing partial interests of like timberland. The appraisers, by product of analyzing actual partial interest sales of timberland arrived at discounts of 55% and 36% respectively while the timberland expert claimed that the discount should be 90%, while the written report prepared by the same expert claimed “at least a 55% discount”. The Court found that a 60% discount was reasonable and supported.

Empirical Market Data – Partial Interest Sale

Locating actual sales of a partial interest is like finding a needle in a haystack. Given the lack of marketability combined with the difficulty of verifying such a transaction can leave appraisers very little to work with. Presented below is a recent example of a partial interest sale that the readers of this article may find useful in their own analysis of a partial interest:

Case Study – Sale of Partial Interest

This study involves the sale of a 1/5 interest in a property identified as Uncas Point Rd. located in Guilford, Connecticut. The parcel is a vacant, non-buildable waterfront parcel that contains .67 acres and was owned by 5 separate owners, each with an undivided 1/5 interest in the land. The value of the parcel is that is provides access to and has frontage along the harbor.

Established factual information of Case Study

Grantor: Jonathan Wallace

Grantee: Carolyn Matthes

Sale Date: July 1, 2010

Sale Price: $3,750 plus $1,000 in assumed property taxes

Volume/Page: 801/340, Warranty Deed

Interest Purchased: 1/5 fee simple interest.

Additional Facts for this Case:

An independent appraiser appraised the property on September 24th, 2007 for $75,000. With documented time adjustments the value of the property as of July 1, 2010 (the conveyance date) would have been $52,500. $52,500 divided by 5 = $10,500. $10,500 would be the value of a 1/5 interest before factoring in any discount. The discount factor derived from this sale would be 55%.

This appraiser interviewed both parties, both of who indicated that they were each acting in their own best interest. Ms. Matthes is a neighboring property owner who lives across the street from the parcel and is attempting to purchase the entire parcel in pieces in order to have a full, undivided fee simple interest in the parcel.

Recent Developments relating to Partial Interest Valuations

Several tax collection departments on the state level have taken the position that no discount would be allowed for a partial interest in an inherited property. This is true of a case in the State of Connecticut where several partial interest valuations were outright denied (after having passed muster on the initial estate valuation). No reason for the denial were given other than that the Department of Revenue Services person requested a meeting with the beneficiaries of the estate being passed on. This in my opinion is just a ploy to get beneficiaries to compromise on the tax liability of the estate.

Clearly a move on the part of the state revenue agencies to generate more income, perhaps to help offset a poorly managed fiscal mess that the state is presently experiencing.

This position is contrary to recent case law, contrary to empirical data and contrary to simple logic. This appraiser recommends retaining a qualified professional or professionals, including that of an attorney who is versed in estate valuation matters.

Marc Nadeau, SRA, is owner of Nadeau & Associates, Guilford, Conn.

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CBRE brokers sale of Stamford Towers - 326,468 s/f Class A office

Stamford, CT The CBRE team of Jeff Dunne, Steve Bardsley, and Travis Langer, in collaboration with David Block, completed the sale of Stamford Towers, located at 680 & 750 Washington Blvd. CBRE represented the seller, CBRE Investment Management, and procured the buyer, a joint venture of Lamar Companies

Sub Halpern DM/VV

T.C. Memo. 2010-104

UNITED STATES TAX COURT

ANDREW K. LUDWICK, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

WORTH Z. LUDWICK, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 3281-08, 3282-08. Filed May 10, 2010.

Paul H. Roskoph, for petitioners.

Andrew R. Moore, for respondent.

MEMORANDUM OPINION

HALPERN, Judge: Respondent determined deficiencies in Federal gift tax for 2005 for Andrew K. Ludwick and Worth Z. Ludwick of $86,529 and $88,785, respectively. Petitioners owned a vacation home as tenants in common, and the only issue for

SERVED MAY 10 2010

decision is the value of the interests therein that they separately transferred in trust to a so-called qualified personal residence trust.

Unless otherwise stated, all section references are to the Internal Revenue Code in effect for 2005, and all Rule references are to the Tax Court Rules of Practice and Procedure.

We round all dollar amounts to the nearest dollar.

Background

Some facts have been stipulated and are so found. The stipulation of facts and accompanying exhibits are incorporated herein by this reference.

Petitioners are husband and wife, and they resided in California when they filed the petition.

In 2000, petitioners purchased unimproved real property on a bluff on the north shore of Hawaii's Big Island. By the end of 2003, they had improved the property by constructing a vacation home. In 2004, they owned the improved property (the property) as tenants in common, each having an undivided one-half interest therein.

In December 2004, petitioners executed agreements establishing separate qualified personal residence trust arrangements. In February 2005, petitioners transferred their undivided interests in the property pursuant to those trust agreements. At the time of the transfers, the property had a fair market value of $7.25 million and an annual operating cost of approximately $350,000.

On their separate 2005 Federal gift tax returns, petitioners each reported a gift resulting from the transfers in trust. They valued their separate one-half interests in the transferred property at a discount of 30 percent; viz, $2,537,500 (0.70 x 0.50 x $7,250,000). In determining the deficiencies in gift tax, respondent allowed a discount of only 15 percent, so that he computed $3,081,250 to be the value of each undivided one-half interest that petitioners transferred. On brief, respondent argues for a discount of no more than 11 percent, which results in a value for each transfer of $3,226,250.

Discussion

I. Introduction

As stated, we must determine the fair market value of each petitioner's undivided one-half interest in the property.

The standard for determining fair market value for purposes of the gift tax 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 knowledge of the relevant facts. Sec. 25.2512-1, Gift Tax Regs. Petitioners bear the burden of proof and do not argue otherwise.

See Rule 142(a).[1] We find that, at the time of the transfer, the fair market value of each undivided one-half interest in the property was $3,000,089, for a discount of approximately 17 percent. We will explain the process by which we reach that result.

II. Valuation of the Gifts

To support their respective valuations, the parties have in part relied on the testimony of experts. We have considered that testimony and have in part relied on it in reaching our conclusion.

A. Method of Valuation

1. The Expert Reports

Petitioners request that we value each undivided interest by discounting half the fair market value of the property ($3,625,000) by 30 percent to reflect the disadvantages of owning an undivided fractional interest in property. Respondent requests a broadly similar approach, although he reaches a different conclusion regarding the size of the proper discount.

Petitioners' expert, Carsten Hoffman, an expert in the valuation of fractional interests in property, relied on analyses of sales of undivided interests and partnership interests.

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[1]Petitioners have not raised the issue of sec. 7491(a), which shifts the burden of proof to the Commissioner in certain situations. We conclude that sec. 7491(a) does not apply here because petitioners have not produced any evidence that they have satisfied the preconditions for its application.

Respondent's expert, Stephen Bethel, also an expert in the valuation of fractional interests in property, relied on analyses of sales of undivided interests, various surveys of brokers, a review of tender offers for majority interests in public companies, and lawyers' estimations of the cost of partition. We do not find the analysis of either expert convincing.

Mr. Hoffman, in his direct testimony, compared the discounts from 69 "undivided interest transactions" between 1961 and 2006. He calculated the mean and median discounts for the set of all the transactions and for three subsets: 16 income-producing properties, 26 parcels of raw land, and 22 transactions involving undivided 50-percent interests. He also provided the range of discounts for all the transactions and for each of those three subsets. He provided no way for us to evaluate his analysis, however. He failed not only to explain how the discounts were calculated (i.e., how did he calculate the underlying fair market value?) but also to provide any measure of the variability or dispersion of his data points (e.g., their standard deviations). Most importantly, he did not provide any of the data; we do not know the specifics of any of the "undivided interest transactions". We have no way to know how comparable those properties were to the one here in issue.

Mr. Hoffman also compared petitioners' property to 10 real property limited partnerships. Yet petitioners' property was never intended to produce income; it was a private vacation home, not a source of revenue. The cashflow statements of the 10 limited partnerships (which held, for instance, apartment buildings and mobile homes) are not relevant.

Mr. Bethel, in his direct testimony, in part relied on four sales of undivided interests between 2002 and 2007. Yet all the sales involved commercial property in the eastern United States. We are not convinced that such data tells us much about the appropriate discount for a multimillion dollar vacation home in Hawaii.

Mr. Bethel also relied on three surveys of California brokers that his firm conducted in 1999, 2005, and 2008. The survey questions involved the discounts associated with fractional interests in property. About 10 brokers responded to each survey by providing a range of discounts and a brief explanation.[2] Yet we have no way of evaluating or of reconciling the brokers' responses because we have no information about the transactions on which the brokers based their opinions. Moreover, the brief explanations are often so cryptic as to

[2]We ignore some responses. For example, one broker opined that the discount associated with the sale of a fractional interest would be 15 percent (he did not give a range), yet the comment beside his estimate stated: "He has never sold a minority position in a tenancy in common, but in his opinion there must be a discount for the position."

reveal almost nothing about the reasons behind the discount ranges. The surveys provide little guidance.

Mr. Bethel also relied on two surveys with brokers regarding so-called pooled public tenancy-in-common investments, which are professionally managed investment properties with multiple owners. Fractional interests in those investments generally trade with almost no discount. In his report, Mr. Bethel conceded that there are "four critical differences" between those investments and petitioners' property,[3] yet he argued that those differences would only "slightly" increase the discount proper here. Mr. Bethel did not explain his conclusion, and, without any reasoning, we are not convinced.

Finally, Mr. Bethel relied on professional review of tender offers for majority interests in public companies. Specifically, he relied on transactions involving the change of control of real estate companies. He calculated the discounts as follows: If the market price were $100 and a buyer tendered $125, then the premium would be 25 percent and the discount would be 20 percent. As Mr. Bethel noted, however, the size of a control premium depends on many factors (e.g., "the buyer's desire or need to acquire the company * * * to complement his present operation")

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[3]Pooled public tenancy-in-common investments are professionally managed, and interests therein are readily marketable, represent ownership in a diverse set of properties, and have relatively steady income streams.

that do not seem relevant to the discount appropriate here. We find the tender offer analysis unhelpful.

2. Partition

At trial, we 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; i.e., the cost to end joint ownership involuntarily by a judicially mandated sale (as a single residential property, the property was unlikely to be divided into separate estates) and to distribute the proceeds appropriately. Both convinced us 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." Downes & Goodman, Dictionary of Finance and Investment Terms 391 (7th ed. 2006). They disagreed, however, as to the size of the appropriate discount and as to whether partition would even be necessary.

Although Mr. Hoffman insisted that a buyer would consider more than just the cost of partition and the marketability risk, he failed to convince us. 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. Indeed, Mr. Hoffman testified:

> And if you have the right to * * * force a partition, you will certainly consider that. And if an investor were to come to me and say, well, I demand an 80 percent discount because it's an undivided interest, I would say, well, that doesn't make sense because you can partition it for significantly less than that, so why would you demand an 80 percent discount.

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. Mr. Hoffman failed to convince us otherwise.

Petitioners concede that Hawaii law provides for partition of real property. See Haw. Rev. Stat. Ann. sec. 668-1 (Lexis Nexis 2007). A buyer would thus be willing to pay an amount equal to the present value of (1) the fair market value of 50 percent of the property upon sale less (2) his costs of maintaining the property and his costs of selling the property (perhaps including the cost of partition). Accordingly, to determine the price that a buyer would be willing to pay, we must figure (1) the length of the partition process, its costs (including the cost of selling the property), and the likelihood partition would be necessary, (2) the rate of return the buyer would demand, and (3) the value of 50 percent of the property upon sale. See Estate of Barge v. Commissioner, T.C. Memo. 1997-188.

B. What a Buyer Would Pay

1. Partition

In partition suits, Hawaii courts may sell real property where partition in kind would be impracticable or greatly prejudicial to the interested parties. See Haw. Rev. Stat. Ann. sec. 668-7(6) (Lexis Nexis 2007). Petitioners do not dispute that partition would result in a sale of the property. Mr. Hoffman testified that a contested partition would take 2 to 3 years to resolve and that its costs would include $10,000 of appraisal costs and $70,000 of litigation expenses. Mr. Bethel testified that a contested partition could take up to 2 years to resolve, and he estimated that its costs would include $15,000 to $20,000 "to proceed with filings", a brokerage fee of 4 to 6 percent, and a closing fee of 1 percent. Mr. Bethel concluded that the total cost of partition would range from 6 to 8 percent of the value of the property. Mr. Bethel testified that, if partition were not necessary, the property could be sold in less than a year.

We find that a contested partition would take 2 years to resolve (including 1 year to sell the property) and that the costs made necessary by the litigation would be 1 percent of the value of the property (that is, $72,500). Petitioners, however, have failed to convince us that partition will always--indeed, will often--be necessary. In fact, when respondent's counsel suggested that partition was "relatively unlikely", Mr. Hoffman seemed to agree.[4] Nonetheless, neither party suggested the likelihood of partition. Bearing heavily on petitioners, who bear the burden of proof, we find that a buyer would expect partition to be necessary 10 percent of the time. We find that the cost of selling the property (which the sellers would bear in any case) would be 6 percent of the value of the property (that is, $435,000). Finally, the annual operating cost of the property was approximately $350,000. We assume that a buyer of a one-half undivided interest in the property would expect to bear only half the costs described above; the buyer would expect the remaining petitioner to bear the other half.

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[4]Respondent's argument is as follows. Suppose petitioner husband had sold his interest. If the buyer then told petitioner wife that he wanted to sell the property, what are the odds that she would object? Not only would he have a right to partition but also a court would ultimately order the property sold (as opposed to divided). Petitioners have failed to explain what (in that hypothetical) petitioner wife would stand to gain by opposing partition. Cf. Estate of Barge v. Commissioner, T.C. Memo. 1997-188 (finding that, in a case in which the property would have been divided (not sold), the other owners might resist partition "to obtain an advantageous partition"). Respondent, however, concedes that such opposition is possible, and we accept that concession.

2. Rate of Return

Mr. Bethel testified that, to account for the marketability risk, a buyer would demand a return of 10 percent. Mr. Hoffman testified that a buyer would demand a return of 30 percent. Nonetheless, he presented no evidence to support that conclusion. Petitioners have failed to prove that a buyer would demand a return greater than 10 percent.

3. Value of Interest After Partition

The parties stipulated that in 2005 the property had a fair market value of $7.25 million. Mr. Hoffman testified that the "long-term sustainable growth [rate] of real estate" was 3 percent annually. Accordingly, at the end of 1 year (if partition were not necessary) or 2 years (if it were) the property would sell for $7,467,500 or $7,691,525, respectively.

III. Fair Market Value

Accordingly, to determine the value of an undivided one-half interest in the property, we use a 10-percent rate of return (discount rate), a partition period of 2 years (including a selling period of 1 year), annual operating costs of $175,000, (possible) partition costs of $36,250 allocated equally to both years, the cost of selling the property ($217,500), and a fair market value of $3,733,750 or $3,845,763 (after a sale in 1 year or 2 years, respectively). We find that the fair market value of the gift that each petitioner made in 2005 was $3,000,089; our calculations are as follows.

If Partition Is Not Necessary

Year	Operating Costs	Selling Costs	Sale Proceeds	Total	Present Value
1	$175,000	$217,500	$3,733,750	$3,341,250	$3,037,500

If Partition Is Necessary

Year	Operating Costs	Partition and Selling Costs	Sale Proceeds	Total	Present Value
1	$175,000	$18,125	--	($193,125)	($175,568)
2	175,000	235,625	$3,845,763	3,435,138	2,838,957
Total					2,663,388

We have found that a buyer would expect partition to be necessary 10 percent of the time. Thus, the buyer of an undivided one-half interest in the property would have been willing to pay the weighted average of the two present values calculated above; that is, $3,000,089.

Decisions will be entered

under Rule 155.