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LUDWICK V. COMMISSIONER, T.C. Memo. 2010-104 (May 10, 2010)

By R. Scott Brace, Jr., ASA

The United States Tax Court (the "Tax Court") did not find either party's experts to be persuasive, so the Tax Court used its own method to calculate an appropriate discount for a fractional interest in a vacation home. A discount of approximately 17% was applied by the Tax Court to the fractional interest.

Overview: Andrew K. Ludwick and Worth Z. Ludwick (collectively the "Petitioner") owned a vacation home on the North Shore of Hawaii's Big Island (the "Property") as tenants in common, and established separate qualified personal resident trust arrangements. In February 2005, each executed a separate gift for a one-half interest in the Property, for which they reported a 30% discount. The IRS (the "Respondent") argued for a discount of 11%, and it was willing to allow a discount of 15% in audit.

The Petitioner's expert relied upon the following: (1) sale transactions of undivided interests (rejected by the Tax Court due to lack of explanation in how the discounts were calculated, lack of any measures of dispersion other than the mean and median, and lack of comparability to the subject interest); (2) sale transactions of real estate limited partnerships (rejected by the Tax Court due to lack of comparability to the subject property); and (3) the cost to partition approach (this was one of the approaches ultimately utilized by the Tax Court).

The Respondent's expert relied upon the following: (1) sale transactions of undivided interests (rejected by the Tax Court due to lack of comparability to the property as "all the sales involved commercial properties in the eastern United States"); (2) surveys of brokers on fractional interest discounts (rejected by the Tax Court as little rationale was provided for the discount ranges); (3) surveys of brokers on pooled public tenancy in common investments (rejected by the Tax Court due to lack of support for critical qualitative assumptions); (4) analysis of tender offers for majority interests in public companies (rejected by the Tax Court as the discount, or premium, "depends on many factors that do not seem relevant to the [appropriate] discount"); and (5) the cost to partition approach (again, this was one of the approaches selected by the Tax Court).

In applying the cost to partition approach the Respondent's expert used a 10% discount rate and the Petitioner's expert used a 30% discount rate. The Tax Court noted that the Petitioner's expert did not present any evidence to support the use of a 30% discount rate, and that the Petitioner failed to prove that a buyer would demand a return greater than 10%. Since the Petitioner bears the burden of proof, the Tax Court utilized a discount rate of 10%.

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Conclusion: The Tax Court valued the subject interest by calculating the net proceeds a holder of the interest would receive under two scenarios: (1) a cooperative sale of the subject property and (2) a forced sale of the property subject to a partition action. In doing so, the Tax Court considered the operating costs of the property and the selling costs that would be incurred. In addition, within the cost to partition approach, the Tax Court also considered partition costs. In both scenarios, the Tax Court utilized a 10% discount rate.

The proceeds to be received in a cooperative sale were weighted 90% and the proceeds to be received from a forced sale of the property as a result of a partition action were weighted 10%. The weighted average value was a discount of approximately 17% to the pro rata value of the fractional interest.

Empire's Commentary: The Tax Court's decision in this case emphasizes the importance of explaining market based data and how it compares to the subject interest as well as thoroughly explaining and supporting all inputs (such as the discount rate) used in the analysis.

The cooperative sale and cost to partition approaches utilized by the Tax Court have been the primary approaches used by Empire in valuing fractional interests in real estate for many years, as most states provide partition rights for co-tenants in real estate. However, based on relevant market data and benchmarks, Empire believes the Tax Court's selected discount rate is too low and does not capture all of the risks inherent in holding a fractional interest in real estate during the expected holding periods (i.e., either the amount of time to sell the property in a cooperative manner or the amount of time required to bring a partition action and sell the property).

Additionally, we believe that the Tax Court should have given more weight in its analysis to the cost to partition approach. In gift and estate tax matters, the buyer is generally presumed to be a hypothetical third-party buyer. In our opinion such a buyer would be more conservative in his or her assessment of value and apply a greater weight to the value derived from the cost to partition approach.

Utilizing an appropriate discount rate and applying greater weight to the cost to partition approach would have resulted in a larger discount to the fractional interest and would have better reflected the interest's fair market value.

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