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FCG VALUATION CASE E-FLASH

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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.

<u>The Court's Analysis</u>

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.

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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