LUDWICK: A WAKE-UP CALL FOR LAWYERS STEVE LEIMBERG'S ESTATE PLANNING NEWSLETTER

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1687
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From: Steve Leimberg's Estate Planning Newsletter
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Our coverage of *Ludwick* [**LISI** Estate Planning Newsletters #1642, 1652 and 1653] provided commentary and analysis by **Paul Hood**, **Owen Fiore** and **Steve Akers**.

Now **Dennis Webb** adds his thoughts to the dialogue. Dennis starts with Judge Halpern's findings and shows how they are connected with partition analysis and more importantly, how members can use the specific process to incorporate the facts of *your* case, and counter with consistent, persuasive arguments that preserve the right discounts. In other words, Dennis's commentary is a guide to protecting your next audit from *Ludwick.*

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Here is Dennis's commentary:

EXECUTIVE SUMMARY:

There is a lot of conversation so far, and there will be a lot of worry, about what *Ludwick* [1] means for valuing tenancy-in-common (TIC) interests in vacation homes (for sure) and maybe for valuing TIC interests generally. Rightly or wrongly, it has the potential to influence valuation practice, and will almost certainly be used by the IRS to challenge discounts.

If you are faced with such a challenge based on *Ludwick*, all is not lost. Counter arguments can be persuasive if they are based on careful investigation and application of the facts. If our experience over the past 15 years is any guide, it is highly unlikely that the correct discount will be as low as 17%.

Facts (should) underlie all applications of valuation processes. But, an important key is to know *which* facts; this in turn requires knowing something about the valuation processes in which they are going to be applied.

FACTS:

The Ludwicks built a large vacation home in Hawaii in 2003. They then established two qualified personal residence trusts (QPRTs) and transferred respective half-interests into each QPRT. At the time of the February 2005 transfers, the fair market value (FMV) of the home was concluded at $7.25 million, and the reported FMV of each interest was discounted by 30%.

COMMENT:

The basics are rarely enough to support a convincing value analysis; in this case, the search for facts has barely begun.

Hawaii law provides for partition, which is effectively a remedy for disputes between co-owners.

Neither appraiser used a model based on partition and the judge found their other arguments unpersuasive. He reasoned that buyers would use the exit costs posed by partition and its likelihood as a ceiling for the market discount, as each would bid up the interest until pursuing the exit strategy would make the buyer whole. The taxpayer's appraiser failed to convince him that this would not be the case.

This reasoning does have its weaknesses, such as the implicit assumption that an action to sell would commence immediately upon purchase. However, it is a generally valid way of looking at one strategy, and such possibility should not be dismissed. The discount depends on the input assumptions, which I will address in the commentary, below.

Reality is that a careful analysis of the facts does not always support a partition action as a reasonable exit strategy. Our analysis of partition strategies usually produces a pretty high discount, demonstrating that such a strategy is frequently not economically feasible.

Besides the general design of the model, another assumption adopted by Judge Halpern was that a heavy weight should be given to a cooperative outcome; that the desire to sell would be unopposed. His assumed the buyer would assign a 90% likelihood to cooperation, leaving only a 10% likelihood of a lawsuit. He cited a limited reasoning presented by the respondent "if the [hypothetical] buyer told petitioner wife that he wanted to sell the property, why would she object?"

Apparently no one asked her. They had just built the property, and she might have good reasons to hold onto it. Market values may no longer be favorable. There are many other facts (below) that can influence such a decision. There was also an agreement between the parties indicating a desire to avoid a lawsuit and sell in the event of a dispute [2]. While there is no indication if the intent demonstrated by the agreement had any influence, such a stated desire might support some likelihood of cooperation. It is unfortunate that a more comprehensive analysis was not undertaken by the appraisers.

For the hypothetical buyer to use this for pricing the interest, there should be affirmative evidence for expecting cooperation. After all, a 90% chance of cooperation means that at a later time, and allowing for influences that are as yet unknown (who else in or outside of the family will have an influence on that decision when the time comes?), a desired sale will be unopposed.

It turns out that the facts in *Ludwick* could support Judge Halpern's decision, and his method is, indeed, applicable to lots of TIC interests. But… changes in fact patterns can have huge effects on the concluded discounts. The commentary below shows how the lawyer can help to identify the material facts affecting value, and suggests that lawyers make sure their expert's arguments are tied to the facts and make sense. The petitioner's evidence in *Ludwick* was short on all counts, making this case an important wakeup call for estate practitioners, and doubly important for the taxpayers they serve.

VALUATION SCENARIOS:

This case uses two valuation scenarios, one for immediate sale of the property, and one that requires a partition action. The comments that follow are for the latter; the immediate sale is much simpler, beginning with a listing to sell.

The present value model used to analyze the partition scenario in Ludwick is generally appropriate:

- Construct a likely timeline between the date of value and the ultimate disposition of the property;
- grow the property value to the end of the period at the current market value growth rate;
- deduct selling costs;
- deduct annual operating costs;
- deduct court and other out-of-pocket costs; and
- discount net sale proceeds and periodic cash flows to present value using a "rate of return that the buyer would demand."

(There is no reference to a loan, but in the event that one is present, debt service and equity at the end of the period would also have to be considered.)

The inputs to the model are critical, and must be based on case-specific facts. But *which* facts should we be looking for? The most important inputs to the present value model, and indeed to all comparisons of market data to case facts, are a) risk to the hypothetical buyer of the interest, and b) the period during which the buyer will be "trapped" in the deal. An analysis of the facts will give the holding period and the discount rate (for calculating present value). Such analysis should be careful and comprehensive, but a few points can be made quickly.

HOLDING PERIOD

- How long would it take for the entire process, from purchase to exit?
- What if the other party were cooperative? What if they were not?

The *Ludwick* case used two years overall, but it might be far longer. If we string together the time from:

- The (presumably agreeable) purchase to
- disagreement to
- negotiation to
- threatening a lawsuit, to

- filing the partition action, to
- court proceedings, to
- sale of the underlying property and
- disbursement of proceeds.

Ludwick ended up with a 1-year partition; *very* fast, which pretty much requires that the lawsuit exit option would commence immediately upon purchase of the interest, and that it would get through the court system with relative ease.

Definitely a fast track, although probably faster than would be expected in most jurisdictions with a policy. If partition is a viable method, then the likely period should be confirmed with lawyers familiar with the process in that specific county.

An additional year was added for marketing the property, closing the sale and distributing the proceeds. However, it would not be uncommon to end up with three years as a reasonable period. If there is a real (temperamental and financial) ability and desire on the part of the other party to obstruct (say, by filing a counter-suit), a realistic period might be even longer.

VALUE GROWTH, PROCEEDS AND COSTS

Market assumptions are included as well. The first is the market-expected value growth rate over the selected period. The case used 3.0%, which is relatively common. What would it be for, say, a property interest gifted today? 0%?

If there is no growth, then selling costs (brokerage fees and other amounts paid in escrow) become significant, and have a big effect on the discount. Partition and any other costs are usually small in relation to the value of the underlying property [3].

DISCOUNT RATE (RISK)

All real estate holdings carry risk, which is built into the purchase price of the property. Risk is increased for a fractional interest holder because its rights are limited, sometimes drastically so. Being trapped in the investment means that the interest holder cannot respond to changing market conditions by selling or borrowing without cooperation.

Market timing is sometimes critical, as recent history will attest, and sale restrictions require substantial discounts for all types of assets.

Risks are also related to the identities of the other owners, personal facts suggested above, and possibly others.

Other sources of risk were broached in the case [4], but apparently not developed to any meaningful extent.

Risk is reflected in a present value model through the use of a discount or yield rate. In *Ludwick*, Judge Halpern used 10%, based on testimony by the respondent's expert. The taxpayer's expert stated that it should be 30%, but provided no support. This is unfortunate, because 10% is essentially a property rate, which reflects only the risk faced by the 100% owner. A properly adjusted rate for the fractional position should be much greater, usually at least 4-5% more.

Given that we are modeling a lawsuit, the rate should be increased still further, from 14-15% to maybe 20% or more. (What return would *you* require to knowingly enter into an investment where your exit could easily be the fun of bringing a lawsuit?) The taxpayer's expert's claim of 30% might have been high, but he was at least moving in the right direction.

Increasing the hypothetical buyer's yield requirement and expected holding period to account for all the facts would substantially increase the concluded discount [5]. Using the facts to determine the appropriate valuation process, and then further fitting the valuation model to the facts, is the essence of the valuation process. It might as well have been a finding of the case, but I suspect Judge Halpern would have been happier if all this had been demonstrated by the experts.

FINDING THE FACTS

It should be apparent by now that even if *Ludwick* is invoked on audit, the facts and circumstances of *your* case are the key to proper analysis and discount conclusion, using a present value or any valuation model. There is usually a fairly long list of facts that influence discounts in these sorts of circumstances, but little is revealed in Judge Halpern's memorandum.

Ludwick is not a reasonable guide to identifying which facts are important in determining value. It points out that holding period and (buyer) risk are key, which is correct, but the reasoning that support the inputs to the model are – in my opinion - woefully lacking.

Accordingly, it can be important, even critical, to ask many more questions. For the Ludwicks:

- How did they use the home? How frequently?
- They had built it only two years before the date of value, so there was not much history; did they intend to hold it for a long time?
- How old are the principals? What about succession - were their children or grandchildren into visiting Hawaii on a regular basis?
- Did they have specific expectations for future usage?

  Why would the hypothetical buyer purchase the interest in the first place? In this case, it would seem that periodic use of a vacation home is a good enough reason. But, how would they model their pricing? Presumably the parties would be agreeable going in, but circumstances change over time, and *any impairment of the exit process would give rise to a discount*.

- Would it be prudent to assume that future cooperation with a buyout or sale would be certain?
- If not, then how likely is litigation?

  A long list of facts that are typically found in fractional interest valuation cases may be found online [6]. Analysis under the fair market value standard relies largely on the hypothetical buyer's pricing process, above. These expectations are, logically, based on this buyer's reasonable due diligence efforts. Given this, important facts should show themselves to any lawyer thinking "buyer due-diligence," and certainly to any qualified appraiser. The appraiser then has the obligation to find analytical models that represent the pricing behavior of the hypothetical buyer and seller. The partition model, from this case, is one such model [7].

WHAT CAN WE CONCLUDE FROM *LUDWICK*?

Even if your facts do not support bringing a partition action as a feasible option available to the hypothetical buyer of the subject interest, a present value model as described above and used by Judge Halpern should have been considered in your appraisal. Its inputs should be supported by a detailed examination of the facts, and its inclusion will put those facts and analysis on record in case of challenge, even if no one in their right mind would pursue such an action.

This case is a wakeup call for the lawyer, who can be directly helpful in the valuation process by checking whether the appraiser's exposition of the facts matches a reasonable due-diligence effort of the hypothetical buyer. There is no reason that the presented analysis, arguments and conclusions of the appraisers should not be tied to the facts, and be clear and easily followed. In their absence, the judge is stuck, and will come up with a decision one way or the other, just as he did in *Ludwick*.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Dennis Webb

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[1] *Ludwick v. Commissioner*, T.C. Memo. 2010-104

[2] *TAM 9336002 Bites Taxpayer*, Carsten Hoffman, FMV Valuation Alert, May 12, 2010

[3] Although expenses are fairly high in this case ($350,000/year), this is still a small amount in relationship to the total property value. Cutting the expenses in half would only reduce the discount conclusion by 2%.

[4] "Petitioners have failed to explain what (in that hypothetical) petitioner wife would stand to gain by opposing partition"

[5] The conclusion of the non-partition model is 16%, and of the partition model is 27%; the 17% conclusion is a weighted average. Most important for nearly all cases is the partition model, and its inputs are important. For example, changing

the (present value) discount rate from 10% to 15% increases the discount concluded by the partition model from 27% to 34%. Acknowledging that the timeline could easily increase by six months for early wrangling between the parties, and then another six months for court delays (*still* a fast track) increases the holding period from 24 months to 36 months. Making *only* this change increases the discount to 37%, and making *both* changes increases the discount to 46%. This does not necessarily mean that the discount conclusion would be as great at 46%, though, because at some point a partition action becomes unfeasible, and other models will be much more usable, providing a better fit to the facts.

[6] See "Asset Fractions: Integrating Real Property and Business Valuations [Getting a Handle on the Facts]" at http://www.primusval.com/presentations.html

[7] There are many valuation models that effectively connect the facts for tenancy-in-common cases, which are quite similar to those for general partnerships and other modified-control entities. Application of the models is discussed in "Advanced Modeling for Holding Company Valuation," also at http://www.primusval.com/presentations.html