

T&E Alert June 4, 2010

In re. Andrew K. Ludwick and Worth Z. Ludwick v. Commissioner T.C. Memo 2010-104 decided May 10, 2010

In this T&E Alert, I am stepping on my soap box in addition to providing “heads-up.” The Ludwick opinion appears to place the entire case law on the subject of fractional real estate interests since *Lefrak* in 1993 on its head ! A long line of Tax Court decisions [TC Memos 1993-526, 1998-59, 2000-53, 2001-258, respectively Estates of Lefrak, Williams, Stevens and Baird] established that the cost of partitioning is only one aspect of determining the discounts from pro-rata fair market value. Judge Halpern, instead, determined that the facts and circumstances here were different, and used a best case scenario to support his valuation: a low 10% chance of a partition, and only 2 years to resolve disputes. What was different about this case ?

The Ludwicks purchased property on Hawaii, and proceeded to build a vacation home worth perhaps \$7 million. They then created separate qualified personal residence trusts, subsequently transferring their undivided interests to the trusts. Gift tax returns were then filed by the husband and by the wife, reporting the value of each 50% interest in the property at pro-rata fair market value, less 30% combined discount for lack-of-control and lack-of-marketability. Upon audit, IRS allowed 15% and subsequent experts concluded at 35% [taxpayer] and 11% [Service.] The Court allowed 17%.

When the taxpayers partitioned the property, they executed a Tenancy in Common agreement, which regulates the property’s management, occupancy, expenses, purpose and how title was to be held. The agreement, according to a published report, also prohibits either co-tenant from seeking a partition [available under state law, but likely to be impractical since this is a one family residence] and also gave each co-tenant the right to sell their undivided interest to the other co-tenant at a pro-rata value of the whole or, alternatively, the right to sell the property in its entirety. The document’s drafter may not have done a good job for his clients since the Court read it as supporting its optimistic calculation described above, that is to say, an arrangement likely to foster a cooperative situation to the effect that the only relatively minor cost would be the cost of partition. We have been unable to find a copy of the agreement; accordingly, we can not comment on the TIC any further.

This is not a large value case, and one wonders why the decision so closely mirrors the Service’s party line on the subject. Perhaps the fact that recreational property was involved, and/or the exact provisions of the TIC led to a reversal of the line of cases. Both appraisers provided data on fractional interest sales, but the court was not interested, and questioned whether they would be comparable. In the final analysis, the Court followed TAM 9336002, a 1993 IRS memo since superseded by TAM 9994003 [The latter replaced the former with a more balanced view, now apparently ignored by the Court.] One gets the impression that the Tax Court does not like fractional discounts applied to non-income producing properties. Beware ! See the opinion at <http://ustaxcourt.gov> and click on the Opinions Search tab. Then search for Ludwick. A copy is at <http://www.NYNJCT-BV.com/ludwick.TCM.WPD.pdf>.

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