

Fractional Interest Discounts: Not If, But How Much

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.

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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 on page 28.

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.

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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

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.

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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.

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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.

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