Dennis Webb on the Bombshell Delivered: An IRS Model Limiting Discounts for Tenants-in-Common

stevesletters@leimbergservices.com

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From: Steve Leimberg's Estate Planning Newsletter

Subject: **Dennis Webb on the Bombshell Delivered: An IRS Model Limiting Discounts for Tenants-in-Common**

Hoping to get a hefty discount for the estate's 95% tenant-in-common interest? Good luck with that. The facts might line up in support of one, but a well-developed model being used by IRS suggests that you might need the stars lined up just right as well. The model was presented by its **IRS Author**, **Neil Mills-Mazer** in a November 11 webinar for business appraisers sponsored and billed as a "bombshell" by Business Valuation Resources.[i] The model has received strong encouragement from **Judge James Halpern**, and it should be understood by all lawyers and other estate planning practitioners.

Now, **Dennis Webb** shows us how the model works, and adds his observations on what IRS really wants. Dennis' own work over the past 17 years shows that understanding what they want allows for taxpayer discounts that are both substantial and unquestioningly acceptable. Dennis has played a seminal role in revealing IRS' valuation viewpoints beginning in 2005, when he developed the ASA-Sponsored series of IRS Valuation Symposia in Los Angeles. He has also worked directly with IRS valuers on how they can adopt various business valuation models in dealing with discounts. The results of this dialogue have produced a body of understanding that works well for both sides.

Dennis A. Webb, ASA, MAI, FRICS is designated in both real estate appraisal and business valuation, and has specialized in fractional interest valuation for more than 15 years. He is a frequent speaker, and his articles have appeared in many professional journals. He wrote the case study textbook "Valuing Undivided Interests in Real Property: Partnerships and Cotenancies" published by the Appraisal Institute. Most of his publications and papers are available at: www.primusval.com. He has reported on the most recent IRS Symposium in Estate Planning Newsletter #1823, demonstrated why arbitrary discount caps are not beneficial for taxpayers in Estate Planning Newsletter #1802, and showed the many on-point issues that were revealed in Case of Ludwick in Estate Planning Newsletter #1687.

Here is his commentary:

EXECUTIVE SUMMARY:

This latest volley from IRS on discounts attributable to tenant-in-common interests was foretold in **LISI** Estate Planning Newsletter #1823, and was just delivered to a wide audience at a November 11 Webinar for business appraisers. It is yet another wake-up call, this time directed at both practitioners and valuers. I predict that many business appraisers and perhaps some lawyers will continue to pretend that the IRS arguments do not work, and both will continue to be wrong.

The situation at issue involves two common tenants, and large discounts that are often applied for the majority holder's interest. The IRS model makes a simple and very strong argument for capping the discount for, say, a 55% interest at 30%, or a 90% interest at 5%(!). This model is premised on the notion that the majority holder would have a strong incentive to buy out the minority, and the minority would have a strong incentive to sell at a premium to its pro rata share. If the premium is significantly greater than the discount that would otherwise be concluded, then the discount would be capped as a consequence of the premium. (See examples, below.) The model has come about because IRS says they continue to see valuations that push the boundaries of common sense.

An approach that ignores Neil's logic will fail. A successful result involves understanding IRS valuers' and the Court's overriding interest in dealing with facts; it does not involve going to war. Ignoring the logic of this minority-buyout scenario will leave open an unaddressed fact set that IRS can and will use to their advantage. Addressing it, along with all the other facts and circumstances of the case, is a key to success that will result in a defensible concluded value. These are issues that you can investigate and understand before the plan is developed, and before the appraisal is prepared and submitted. You can take action directly to both keep your clients out of audit trouble and obtain major efficiencies from asset value discounting in wealth transfers.

Please note that the views and opinions expressed are those of Mr. Mazer and do not necessarily reflect the views and opinions of the IRS.

COMMENT:

The tenant-in-common structure for real estate has the potential to divide ownership simply, and in a way that generates significant discounts for gifting and estate purposes. It is also very easy to mess up both the structuring and the valuation. It might not seem so, but according to Neil Mills-Mazer,[ii] IRS sees a lot of taxpayer assertions that are just not credible, and the situation is not improving.

Mr. Mazer first introduced his model in 2007, at the Second National IRS Symposium in Los Angeles. It had received mixed reviews until our most recent Symposium last May, where the panel also included Judge James Halpern and myself. His model took on a new credibility when Judge Halpern agreed rather strongly with the premium buyout premise.[iii]

Why would a hypothetical seller part with the interest at a deep discount when an alternative would be to buy out the minority holder at a huge premium to its pro rata share? The seller would then own the entire property, and could sell it at no discount whatever.

Mr. Mazer's model begins first with an analysis of the discount using other methods, such as partition cost, comparison with fractional interest transactions, and others. In his Webinar example, actual transactions usually suggest discounts of around 24%, and partition analyses suggest 28% to 45%. Say the analysis comes up with 35%. (I generally agree with these discounts as an example. It is interesting that his example uses discounts greater than many practitioners say they are comfortable with. Hmmm…) But the fact not yet addressed is that the subject is a 95% interest. His stated position is that "the 95% owner would not be willing to take such a drastic reduction when a more attractive alternative is available. He could offer to buyout the 5% holder equal to her pro-rata share or at a slight premium, thus gaining a full 100% interest, and then being able to sell with no discount at all. So the question then becomes, what is that acceptable premium and the correlation of the discount on the majority holder?"

An explanation of the model requires several numerical examples, and Neil has developed a table of what he considers acceptable premia. He was required to make a fairly careful explanation of these in front of an audience of experienced valuers, so you may digress if you require a more intimate understanding of its workings. The table and examples are included in a long note to this commentary.[iv]

The model requires some judgment as to what would be reasonable limits for a premium – at what point does the minority just sell? Neil reasons that a very small interest might require a pretty sizeable premium, close to 100% of their pro rata interest, to induce a transaction. A larger minority interest would need a lesser premium; his example shows a 35% minority accepting a 37% premium, which would effectively cap the 65% majority interest discount at 20%.

This argument is strengthened if the offer to buy out the minority could be made under threat of partition (assuming such right has not been correctly waived, a commonly-used technique that is also fraught with risks), in which case the minority could also be hit with more costs and be denied any premium. It is weakened if there is no ability to make such threat.

Keep in mind also that, under the fair market value standard, we postulate a hypothetical buyer/seller for the interest being valued. However, the minority holder is not hypothetical; he or she is known, at least at the date of value. You can often ask them whether they would sell (hypothetically!), and get very interesting answers.

The model gives an indication of what Neil would consider reasonable when examining your client's discount valuation report. He has made clear that the facts could require that he grant a much greater discount, but that they also might argue for an even more severe restriction. He looks at other methods as well, and would weight the discount indications of this usually more-restrictive model when very large percentage interests are valued, but its weighting might drop for smaller (approaching 50%) percentage interests. All depends on the facts of the case. But, when your valuation gets to him, are the facts in evidence? He won't introduce new facts in his examination, and if the taxpayer's valuation report does not include them, then the minority premium argument will be advanced, and IRS is likely to win.

Neil's reliance on fact patterns supports the underlying theme that IRS has been consistently putting out at one Symposium after another, and a theme that was most recently echoed by Judge Halpern. You can also find the same idea over and over again in tax court memoranda. This long-running issue is not new, and it's not a bombshell; it's just ignored a lot. What are the facts? How does your valuation analysis tie to the facts? And does your story offered in support of the value conclusion make sense?[v] Apparently 95/5 tenants-in-common, or even 99/1, are not uncommon. But why would you create that circumstance in the first place? There indeed good reasons for expecting for no buyout at even a very high premium, but you are making way for a potentially convincing argument to be offered by IRS; one that the Court may strongly favor. With discounts of 25% to 40% or more available for common tenancy positions generally, why overdo it?

Conclusions

The model presented by Neil Mills-Mazer is used in his examinations of discount valuations. It requires that the valuer consider whether a majority holder of a fractional interest in real estate would be able to consolidate its hold on the property by buying out the minority holder, and then selling the property to exit as he wished. He suggests that such buyout should be considered as an alternative of the hypothetical seller, but not that it is certain or even determinative, pending consideration of the other case facts. It is clear that a buyout scenario should not be ignored. Absent a good analysis, IRS will have a wide opening to advance a compelling argument that has a good chance of persuading the judge. This does not necessarily mean a discount cap, although this is more likely for very large percentage interests. It will often make sense.

It does seem strange that IRS would continue to see valuations that appear to push against the boundaries of common sense, but they do; and in this case they can easily have a strong position. Knowing this, there are several specific steps that a practitioner can take to avoid placing their clients, and their carefully constructed estate plans, in jeopardy:

- Stay away from wildly unbalanced ownership structures. What is the point of creating a 99% holder and a 1% holder? Even a small discount for the larger interest strains credibility.

- Make sure the evidence for value (the appraisal) addresses all material facts. If ignored, IRS will insert their own, and Mr. Mazer's arguments will win (at least in Judge Halpern's courtroom).

- Make sure the valuation connects the facts with its process, and that the story it tells is logical and can be easily understood. Both IRS and the courts regularly plead for such a story. Give it to them.

The tenant-in-common structure is a very useful estate planning tool, and it can legitimately generate large discounts. However, it is very often done in a way that places the taxpayer and all its benefits at risk. Why? I could speculate, but a careful plan that accounts for the facts, and a quality valuation that does the same, is the best strategy for realizing tax benefits that stick.

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

Dennis Webb

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CITATIONS:

[i] Business Valuation Resources is publisher and supplier of products and services for the business valuation profession, at www.bvresources.com. The webinar titled "Valuing a Majority Fractional Interest" is Part 4 of BVR's 2011 Online Tax Summit, and took place on November 11, 2011.

[ii] Mills-Mazer, AVA, JD, has been with the Internal Revenue Service for 23 years, and currently holds the position of Engineer Team Manager in Los Angeles. Previous positions with the IRS included Valuation Specialist, Financial Products Specialist, Appeals Officer, and Revenue Agent. Mr. Mazer received his bachelor's degree in Accounting from Central Connecticut University and his Juris Doctorate from Western State University College of Law in Fullerton, CA.

[iii] Judge James Halpern (USTC) appeared as a featured speaker at the Third Annual National IRS Symposium on Valuation Issues that was held in Los Angeles, May 18, 2011. His comments were made on a business valuation panel that included Neil Mills-Mazer, Chris Treharne and Dennis Webb.

[iv] What is the acceptable premium, and how does it correlate with the discount applicable for the majority holder's interest? The following examples show the minority premium, and Mr. Mazer's take on what premia should be acceptable for different ownership percentages.

		Interest Holders	
		95.0%	5.0%
Property value	$4,000,000	$3,800,000	$200,000
If discount	35.00%	1,330,000	1,330,000
		$2,470,000	$1,530,000
Indicated premium for minority interest holder			665.0%

This calculation shows what would happen if that 35% discount were attributed to the 95% interest. The majority holder would effectively be in the same position as if he paid the minority holder her $200,000 pro rata share of the $4,000,000 property plus the discount, another $1,330,000, which would be 665% of the minority's pro rata share. Would the minority entertain a sale of her interest at such a premium? The facts may say that she would require at least that, but those would be pretty unusual facts.

What are reasonable premium limits? Neil has provided us with a chart (simplified here) that shows his estimate of reasonable premia for different size minority positions when valuing the corresponding majority interest.

Discount Allowed	Minority Interest						
	1%	5%	10%	15%	25%	35%	45%
1.0%	99%	19%	9.0%	5.7%	3.0%	1.9%	1.2%
5.0%	495%	95%	45%	28%	15%	9.3%	6.1%
10.0%	990%	190%	90%	57%	30%	19%	12%
15.0%	1485%	285%	135%	85%	45%	28%	18%
20.0%	1980%	380%	180%	113%	60%	37%	24%
25.0%	2475%	475%	225%	141%	75%	46%	31%
30.0%	2970%	570%	270%	170%	90%	56%	37%

▓ Range of premia considered too low
▒ Range of premia considered reasonable
░ Range of premia considered too high

The chart shows that an "acceptable" premium for a 5% interest would be 95%, and this would equate to a discount on the corresponding 95% majority interest of 5.0%. The new arithmetic is:

		Interest Holders	
		95.0%	5.0%
Property value	$4,000,000	$3,800,000	$200,000
If discount	5.00%	190,000	190,000
		$3,610,000	$390,000
Indicated premium for minority interest holder			95.0%

In general, the acceptable range of premia decline as the size of the interest increases. What about a larger interest, say 35%/65%?

		Interest Holders	
		65.0%	35.0%
Property value	$4,000,000	$2,600,000	$1,400,000
If discount	20.00%	520,000	520,000
		$2,080,000	$1,920,000
Indicated premium for minority interest holder			37.1%

The greatest acceptable premium for this size interest (in Mr. Mazer's view) is about 37%, which would allow for a discount for the majority interest of 20%. All these conclusions are meant to be one element of a soup of discount conclusions and facts that should be reconciled to produce the appraiser's conclusion. Mr. Mazer has indicated that he might reconsider the earlier 95% premium for the minority excessive based on the facts, and might even cap the discount below the 5% shown in the example. He also indicated that he would give this method a high weight when valuing very large percentage interests, but that weighting might drop for smaller (approaching 50%) percentage interests, depending on other facts of the case.

[v] A fact shopping list for real estate interests was prepared by Dennis A. Webb, ASA, MAI, FRICS with BVR Staff, and published in "Getting the Facts: A 32 Point Checklist for Fractional Interest Valuations," Business Valuation Update, Business Valuation Resources, (July 2011): 1-4. It is a formula for successful discount valuations, and was included by BVR in the reference materials for the November 11 Webinar.