

ASFMRA 2011 IRS Seminar

MARKET ABSORPTION DISCOUNTS

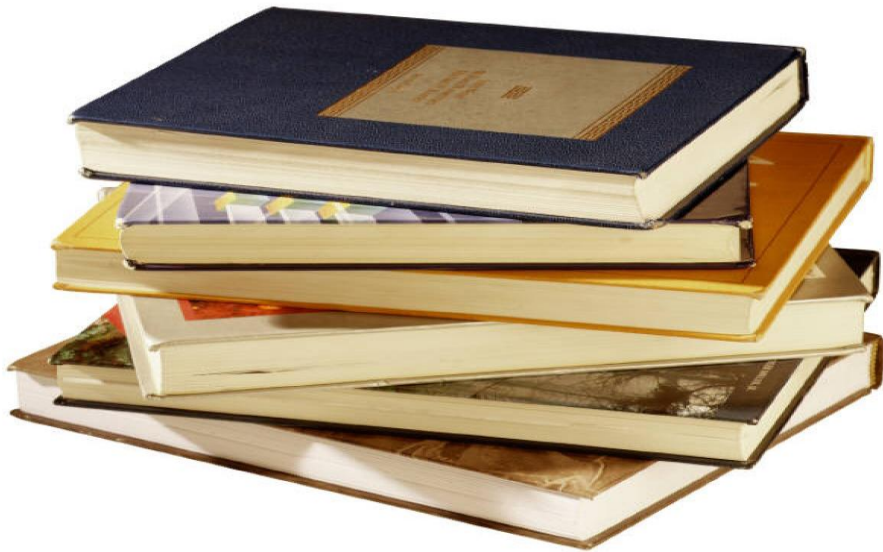


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Valuation and Financial
Advisory Services





Definition - Tax Court - Estate of Auker

"Blockage" is the "Recognition in the field of taxation of the fact that in some instances a large block of stock cannot be marketed and turned into cash as readily as a few shares.



Definition - Tax Court - Campbell v. U.S.

The term "market absorption" is more commonly used in the valuation industry to describe the blockage effect on assets other than stock. We use the term "market absorption" when we refer to blockage as applied to assets other than stock. "Campbell v. United States, 228 Ct. Cl. 661, 661 F.2d 209, 219 n.12 (1981)"



MARKET ABSORPTION

Market Absorption Discounts are used frequently by appraisers and the use is mandated by laws, regulations and court decisions.

1. USPAP
2. Federal Reserve
3. Appraisal Practice
4. Tax Courts



MARKET ABSORPTION

1. Uniform Standards of Professional Appraisal Practice (“USPAP”):

Standard Rule 1-4 (e) states that “when analyzing the assemblage of the various estates or component parts of a property, an appraiser must analyze the effect on value, if any, of the assemblage. An appraiser must refrain from valuing the whole solely by adding together the individual values of the various estates or component parts.”



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2. Federal Reserve Lending Guidance:

For a building or subdivision with “five or more units, an institution must obtain an appraisal of the property that reflects appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. An institution may not use the aggregate retail sales prices of the individual units as the market value to calculate the Loan to Value (‘LTV’) ratio.”



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3. Appraisal Practice Examples:

- A 50-lot subdivision for a bank loan
- A group of 10 houses in an estate in the same competitive market
- A ranch with a large area of deeded land and no sales



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Ranch Example:

- 760 Acres - Largest parcel of deeded land in a market area.
- Limited sales of land, and no sales of parcels of similar size.
- An emerging market for large “ranchettes” as second homes. Usually 40-acre parcels.
- Purpose for estate taxes, second death.

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Ranch Example:

Sale No.	Date	Acres	Price	Price Per Acre
1	4/13/2004	74.15	\$750,000	\$10,115
2	5/22/2004	53.66	\$500,000	\$9,318
3	7/15/2004	80.00	\$700,000	\$8,750
4	Escrow	160.00	\$925,000	\$5,781
Subject	8/13/2004	760.00		

All sales are within 4 miles of subject property

MARKET ABSORPTION

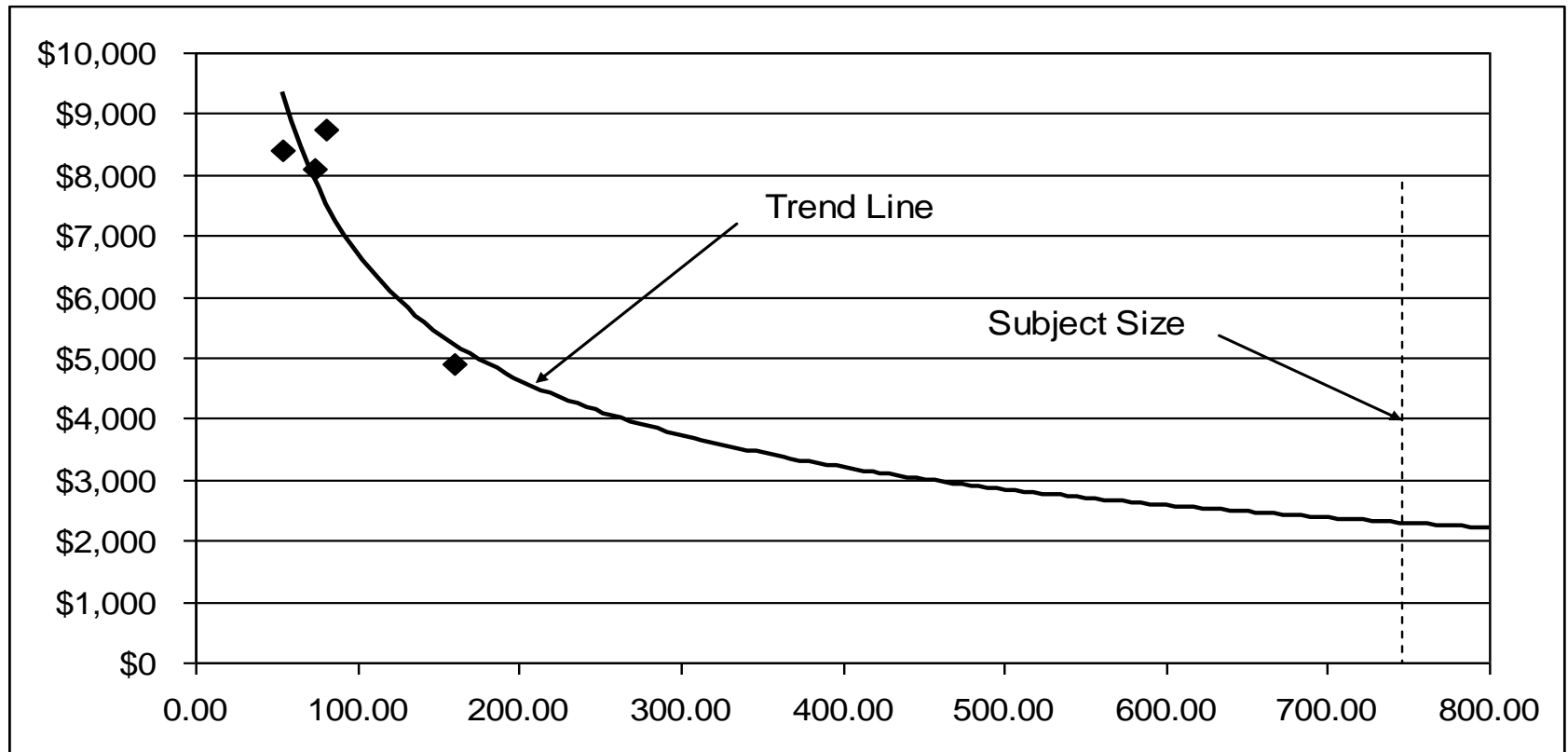
Ranch Example:

Sale No.:	Subject	1	2	3	4
Adjusted Price Per Acre:		\$10,115	\$9,318	\$8,750	\$4,914
Physical Adjustments					
Location:		Similar	Similar	Inferior	Similar
Adjustment:		-10.0%	0.0%	10.0%	0.0%
Size (Acres):	760.00	74.15	53.66	80.00	160.00
Adjustment:		0.0%	0.0%	0.0%	0.0%
Terrain:		Superior	Superior	Superior	Similar
Adjustment:		-10.0%	-10.0%	-10.0%	0.0%
Total Adjustment:		-20.0%	-10.0%	0.0%	0.0%
Indicated Value:		\$8,092	\$8,386	\$8,750	\$4,914

Adjusted for all differences except size.

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Ranch Example:



Graphed data to show relationships (Diminishing marginal returns)



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Ranch Example:

- Conclusion was \$2,000 to \$2,500 per acre.
- No support for size adjustment.
- Looked at highest and best use for sales as 40-acre parcels.
- Established how the property could be divided. 13 lots to allow for terrain issues.



MARKET ABSORPTION

Ranch Example:

- First found sales of small parcels and estimated value at \$7,500 per acre in 40-acre parcels.
- Estimated market absorption. Looked at sales of land in area and estimated 2 to 3 lots per quarter.
- Estimated development costs, sales and other costs. Also looked at time to entitle the land for development and sales.

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Ranch Example:

QUARTER	1	2	3	4	5	6
INCOME						
Sales/Qtr.:	0	0	2	3	2	3
Price Per Lot:	\$300,000	\$303,750	\$307,547	\$311,391	\$315,284	\$319,225
Total Sales:	\$0	\$0	\$615,094	\$934,174	\$630,567	\$957,674
EXPENSES						
Infrastructure:	\$279,839	\$0	\$852,111	\$0	\$0	\$0
Sales & Marketing 6%:	\$0	\$0	\$36,906	\$56,050	\$37,834	\$57,460
Administration: 6%:	\$36,000	\$36,270	\$36,542	\$36,816	\$37,834	\$57,460
Taxes:	\$4,813	\$4,837	\$4,113	\$3,006	\$2,266	\$1,139
Total Expenses:	\$320,652	\$41,107	\$929,672	\$95,873	\$77,934	\$116,059
Cash Flow:	(\$320,652)	(\$41,107)	(\$314,578)	\$838,301	\$552,633	\$841,614
Present Value:	(\$305,383)	(\$37,285)	(\$271,744)	\$689,672	\$433,003	\$628,026
Total Present Value:	\$1,735,214					
Value Per Acre:	\$2,283					

Discounted cash flows at 20% indicating value near Sales
Comparison Approach





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4. Tax Court Decisions:

- Estate of Glick - 1997
- Estate of Auker - 1998
- Estate of Brocato - 1999
- Estate of Rogers - 1999
- Estate of Langer - 2006
- Estate of Astleford - 2008



MARKET ABSORPTION

Estate of Glick - T.C. Memo 1997-65

One of the more recent cases on the use of the Discounted Cash Flow (“DCF”) Analysis to value land. Land was valued using a subdivision method by both appraisers for non-cash charitable donation.

“.. the expected net proceeds are discounted over the estimated period required for market absorption of the developed lots in order to determine the amount a developer would pay for the undeveloped property; i.e., the property's fair market value.”



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Estate of Auker - T.C. Memo 1998-185

- Noted that assets must be poorly diversified in order to be subject to market absorption discounts.
- The court did not allow a market absorption discount based on an across the board 15% discount. Also denied based on sales of discounts from RTC transactions.



MARKET ABSORPTION

Estate of Auker - T.C. Memo 1998-185 (Cont'd)

- The first case on market absorption with clear methodology. A **five-step approach**:
 - **First**, categorize the assets by type.
 - **Second**, estimate the market value of each asset assuming each asset will be marketed separately.
 - **Third**, compare the number of assets to the number of assets of that type which are traded in the market over a reasonable period of time.



MARKET ABSORPTION

Estate of Auker - T.C. Memo 1998-185 (Cont'd)

The five-step approach continued:

- **Fourth**, estimate how much longer than the reasonable time period it would take to sell each asset that could not be sold in this reasonable time period.
- **Fifth**, discount the value of each asset in the category of assets that cannot be sold within a reasonable time period, taking into account the time value of money.



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Estate of Rogers - T.C. Memo 1999-129

- IRS cited Estate of Auker to deny market absorption discount for properties held in an entity. The Court disagreed.
- IRS proposed that since entity had no plans to sell properties, that absorption discount could not be applied. The Court disagreed.
- The parties stipulated to pre-discount market value.



MARKET ABSORPTION

Estate of Rogers - T.C. Memo 1999-129 (Cont'd)

- The Court determined that the IRS appraiser was inconsistent in that he used DCF method in valuing income properties but not the unimproved properties.
- Taxpayer appraiser used discount rate of 23% based on an analysis of an industrial subdivision. Court denied the rate and said one data source was inadequate.
- Court excluded some properties as the highest and best use was not for resale.



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Estate of Brocato - T.C. Memo 1999-424

- Estate included 9 apartment properties held in trust. The properties were located in San Francisco.
- Taxpayer claimed a 12.5% discount on 8 buildings excluding a duplex.
- IRS claimed a 1.92% discount for market absorption of 7 properties with 12 to 18 units and excluded the apartment with 42 units. Court disagreed with the IRS discount but agreed with the number of units addressed by the IRS appraiser.



MARKET ABSORPTION

Estate of Brocato - T.C. Memo 1999-424

- Court used a DCF analysis to establish final discounted value of 11%. The court was silent on the discount rate, but presumably used taxpayers rate.
- The primary issue addressed by the Court was the absorption. The Court allocated three pages of the decision to the number of listings and sales in the area before determining the absorption rate.
- Primary take-away is to make sure that assets subject to market absorption are comparable.



MARKET ABSORPTION

Estate of Langer - T.C. Memo 2006-232

AKA Doing it right and explaining it wrong.

- Estate included two parcels of land near Portland, Oregon held in an LLC.
- Both appraisers used DCF analysis to establish the pre-discount value, but there was a wide spread in values.
- Court used two sales used by each appraiser that were the same and disregarded all other transactions. The Court then appraised the two properties based on the two sales.



MARKET ABSORPTION

Estate of Langer - T.C. Memo 2006-232

AKA Doing it right and explaining it wrong. (Cont'd)

- Taxpayer appraiser valued properties noting that supply and demand factors would not allow sale of property for three years at the value conclusion. Then did three year DCF.
- Court noted that the taxpayer appraiser stated that he valued the property assuming a sale would occur three years in the future. Due to this explanation, the Court denied the DCF absorption adjustment as it did not address the value of the property on the date of valuation.
- If he would have explained that to sell the property at the date of valuation, a buyer would have priced the land to hold for three years, the decision might have been different.



MARKET ABSORPTION

Estate of Astleford - T.C. Memo 2008-128 Most Recent Case on Market Absorption

- Addressed both tiered discounts and market absorption.
- Property in question was 1,187 acres of farmland in Minnesota.
- Taxpayer appraiser recognized property was large and unique as average farm size in market was 160 acres.
- IRS valued land at \$3,500 per acre and did not address market absorption.



MARKET ABSORPTION

Estate of Astleford - T.C. Memo 2008-128 Most Recent Case on Market Absorption (Cont'd)

- Taxpayer appraiser valued land at \$3,000 per acre and used a 25% internal rate of return to discount future land sales to present value over four years.
- Court concluded at \$3,500 per acre and used a 10% discount rate over 4 years to value the property.
- The Court adopted a deduction of the cost of sales and holding expenses over the projection period.



MARKET ABSORPTION

Real World Examples:

1. Portfolio of homes (highest and best use must be addressed)
2. Industrial buildings
3. Portfolio premiums vs. portfolio discounts



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Lessons Learned:

- Market absorption must be addressed per USPAP, federal regulations and Tax Court decisions.
- Fair Market Value before discounting is always important. Don't over-look. Make sure there is explanation of sales and adjustments, and well-supported highest and best use.



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Lessons Learned:

- Make sure to provide explanation of categories of properties that are subject to market absorption.
- Do not use case law or formulaic estimates of market absorption discounts. Use only market derived estimates.
- Deduct costs of holding the properties and sales expenses. Also, address interim income. Not addressed in case law, but covered in USPAP and other regulations.



Valuation in Troubled Times

- Interim Guidance Memorandum, SB/SE-05-0209-006, Interim Guidance for Additional Review of Real Property Valuations in Offer in Compromise Cases
- “During these current economic times the value of real property may be difficult to determine in specific markets and is frequently an area of dispute in the computation of reasonable collection potential.”
- “All employees should be sensitive to the current economic conditions that may be affecting taxpayers while investigating the acceptability of an offer. Employees should continue to utilize all available resources to arrive at the most accurate property valuation possible.”



FMV Opinions

- Valuations from under \$1 Million to over \$10 Billion
 - Experience With Public & Private Entities
- Experienced Team of Professionals
 - Staff of Approximately 50 Professionals
 - Alum From “Big Four”, I-Banks, Houlihan, Business Operations, Commercial Lending
 - Five Office Locations:
 - Irvine, San Francisco, New York, Dallas, Chicago
 - Senior Management Involvement in Each Project
 - IRS & Court Experience
 - IRS Audit Rate Well Below Industry Average



FMV Opinions

- Real Estate Valuation Services
 - Valuation Opinions
 - Portfolio Evaluation
 - Estate & Income Tax
 - Financial Reporting
 - Workout and lender support
 - Litigation Support
 - Extensive court room experience (Robert Dietrich with over 60 appearances in court as an expert witness)
 - Eminent domain
 - Bankruptcy



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■ Business Valuation Services

• Valuation Opinions

- Corporate Planning
- M&A, Recaps, Shareholder Buyouts
- Estate & Income Tax
- Recognized Leader in Estate & Gift
- Financial Reporting
- Purchase Price Allocations & Option Valuations
- Transactional Opinions
- Solvency & Fairness

• Litigation Support

- Valuation & Quantification of Lost Profits & Damages
- Partner Dissolution, Buy/Sell

