

Valuation

STRATEGIES

JANUARY/FEBRUARY 2012



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ARE JUDGES AVOIDING THE DIFFICULT TASK
OF CALCULATING ACCURATE VALUES
WHEN THEY ARE FACED WITH
DETERMINING VALUATIONS OF INNOCENT-
OWNER TAX LIENED PROPERTY?

NEAL NUSHOLTZ

TAX LIEN VALUATION AND **PROBABILITY THEORY**



Edward De Bono, who writes about thinking, says the only time one has to make a decision is when one has inadequate information.¹ If

lost at a fork in the road, choosing left or right is necessary because the traveler does not know which way leads to the destination. Indisputably, a lack of information makes a decision more difficult.

Valuing property, for example, is easy when there are many timely comparable sales, and the sales are all at or around the same price. Sometimes, however, missing information relates to future events, and that generally means that a decision may become a matter of probability. Not surprisingly, financial decisions based on probabilities can translate into lost money, which has happened in the federal courts with regard to tax lien valuations.

Tax lien valuations generally arise when the IRS asserts its tax lien on property in which persons other than the delinquent taxpayer hold a property interest. The Supreme Court has held in three cases that tax liens can attach to property as to which the delinquent taxpayer has shared or limited property rights, or even no current property rights at all. In *Rodgers*,² the Court held that if a married couple jointly owns a home and one of them owes taxes, the entire property can be sold in a tax foreclosure under Section 7403, and the nondelinquent spouse, despite state homestead rights, is entitled only to compensation for the value of his or her interest. In *National Bank of Commerce*,³ the Court held that where only one of the account holders on a joint bank account owes taxes, then so long as the delinquent taxpayer has withdrawal rights over the account, the government may withdraw by levy the entire account. Finally, in *Drye*,⁴ the Court held that when a delinquent taxpayer effectively disclaims his or her inheritance under state law, even though he or she never owned the property and would never own it, the tax lien against the delinquent taxpayer heir

attaches to the property that the taxpayer could have received from the decedent[esq]'s estate.

In cases in which the government asserts its lien on property interests owned by an innocent third party, the property that is liened but not owned by the taxpayer must be valued, so that the nondelinquent owner can be compensated. Given the size of the national debt and the government's need of revenue, tax liens on third party property could well be pursued with increasing vigor.⁵ Therefore, valuation controversies in the lien and foreclosure context may be expected to increase in number.

Valuation on Sale, Death, or Divorce

In situations such as *Rodgers*, a nondelinquent spouse's rights in a marital home must be valued and compensated. But ordinarily, the value of each spouse's separate interest can be determined definitively only if there has been a consensual sale, a death, or a divorce, in which case state law typically spells out with clarity the amounts to which each spouse is entitled. Otherwise, the true value of the spousal rights is really an open question. For example, with a tenancy by the entireties, in which each spouse has a right of survivorship, the real value of either spouse[esq]'s interest depends on the extent to which that spouse is likely to survive the other. If divorce would sever the joint tenancy and entitle each spouse to one half of the value of the property, the likelihood of divorce also affects value. The valuation of a spouse's interest in a home, therefore, is dependent on future facts. As to survivorship rights, those facts are the same as those that surround valuation of a life estate.

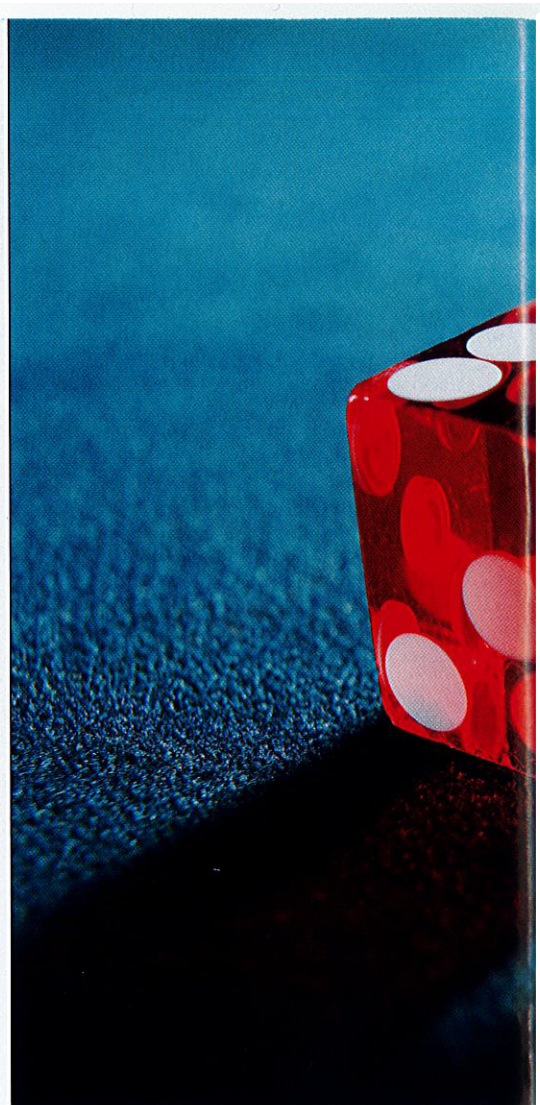
When the issue of how to value an innocent wife's homestead rights first came up in *Rodgers*, it was not the central issue. The Supreme Court, in a passing comment, suggested that a 30-year-old wife might own 99% of the home based on her life expectancy. In doing so, the Court noted some problems:

First, the nature of the market for life estates or the market for rental property may be such that the value of a homestead interest, calculat-

ed as some fraction of the total value of a home, would be less than the price demanded by the market for a lifetime's interest in an equivalent home. Second, any calculation of the cash value of a homestead interest must of necessity be based on actuarial statistics, and will unavoidably undercompensate persons who end up living longer than the average.

Two lower federal courts have approached this issue in a different way, ignoring the actuarial issue. In *Popky*,⁶ a Pennsylvania district court, finding the issue quite complicated, held that each spouse's marital interest should be 50%:

However, this approach relies on a speculative prediction that both spouses will have an average life span and it neither accounts for the health of the spouses nor for the likelihood of divorce or a sale of the property with the consent of both spouses which could break up the tenancy by the entireties. To include these factors would make valuation infinitely more complicated and would again reach a valuation based merely on speculation. I conclude the only



NEAL NUSHOLTZ is a tax attorney in Birmingham, Michigan.



equitable solution to the valuation of Mrs. Popky's interest in the entireties property is to divide the proceeds equally between her and Dr. Popky. The federal tax lien can therefore properly attach to one-half the value of the proceeds from the sale of the Margo Lane property.

The Third Circuit affirmed this approach.⁷

In *Barr*,⁸ the Sixth Circuit made an end run around the problem by first ruling that under state law a husband and a wife are presumed to have equal

life expectancies, stating that "Mrs. Barr presents no compelling reason why this court should not apply the presumption of equal spousal life expectancy implicit in Michigan law." The *Barr* court then ruled that life estates can be ignored in valuations of tax-liened property held as tenancy by the entireties.

The path to their conclusions may have differed, but in the end both the *Barr* and *Popky* courts determined that one-half of the sale value represented the cash value of the separate interest of a spouse.

When valuing a spousal interest based on a sale, the resulting valuation will be one half of the net selling price as each spouse has an equal interest and their separate interests are mutually exclusive. That is, when one joint owner owns a portion of a sum of cash, the other cannot also own the same portion. Therefore, equal means half. In contrast, when valuing the benefit of the lifetime use of a home, "equal ownership" does not mean that a joint owner has only a right to the use of only half the home.⁹ Although half of sale value is the easiest value to calculate, it may undercompensate an innocent spouse who places a higher value on continued use of the entire marital home, and it would undercompensate a spouse who might have obtained the entire marital home in a potential divorce.

Probability Theory

Over time, will the 50-50 split ordered in *Popky* and *Barr* produce the most revenue for the government when compared to other methods of valuation? Accepting a few assumptions and applying probability theory will show how this might happen. Assume that there is a married couple with a marital home, held in both names, that is valued at \$600,000. Further assume that the husband is older, has a delinquent tax liability, and has no other assets, and that the wife has \$400,000 of her own assets and owes no taxes.

Here are the assumed probabilities:

1. The husband has a 22% chance of becoming the sole owner of the home by surviving his wife and enjoying the entire \$600,000 value.
2. He has a 56% chance of living long enough to benefit from lifetime use of the home, valued at approximately \$200,000.
3. He has a 22% chance of living in the home long enough to benefit in the amount of \$400,000.¹⁰

On divorce, the husband has two possibilities for an equal split of the combined \$1 million marital estate:

1. A 49% chance that he will get the whole \$600,000 house but will owe his wife \$100,000 (netting \$500,000).
2. A 51% chance that his wife will get the home in a divorce, but she will owe him \$100,000 and he will get the other \$400,000 (also netting \$500,000).

¹ De Bono, *de Bono's Thinking Course* (Facts on File, 1982).

² 461 U.S. 677, 52 AFTR2d 83-5042 (1983).

³ 472 U.S. 713, 56 AFTR2d 85-5210 (1985).

⁴ 528 U.S. 49, 84 AFTR2d 99-7160 (1999).

⁵ In 2009, for the first time, Section 7403 litigation made the top ten list of IRS litigated issues in the federal courts. National Taxpayer Advocate 2009 Annual Report to Congress, Executive Summary Preface & Highlights, p. 42.

⁶ 326 F. Supp. 2d 594, 94 AFTR2d 2004-5157 (DC Pa., 2004).

⁷ 419 F.3d 242, 95 AFTR2d 2005-2464 (CA-3, 2005).

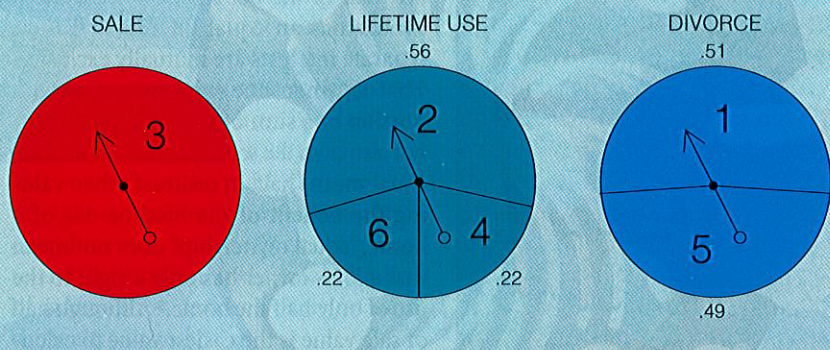
⁸ 617 F.3d 370, 106 AFTR2d 2010-5590 (CA-6, 2010), *cert den.* _U.S._ (3/21/2010). *Barr* was a

2-to-1 decision. In a more recent unpublished *per curiam* decision, Sixth Circuit Judge Helene N. White said she thought the 50/50 decision in *Barr* was "incorrect." See Barczyk, 108 AFTR2d 2011-5862 (CA-6, 2011).

⁹ See *Estate of Gutches*, 46 TC 554 (1966) (A "husband's use of the property by occupancy... is a natural use which does not diminish [the] wife's enjoyment and possession and which grows out of a congenial and happy family relationship.")

¹⁰ The probabilities and values used in this example were selected for purposes of illustrating how a statistical analysis can be used to value tax-liened property where possible future events have different cash values and probabilities of occurring.

EXHIBIT 1 Probability Spinners



These assumptions, the three methods of valuation, and the probabilities associated with the dollar figures for each method of valuation are shown in Exhibit 1.¹¹

Which method is statistically likely to produce the most revenue? The statistical answer would be the method under which valuation of the tax lien is most likely to result in the highest number for the husband's interest. The method for doing this can be shown by treating the spinners in Exhibit 1 as a gambling game where a statistician is trying to determine which spinner is the best bet based on which can win the most and how likely it will be the overall winner (also called the "expected value").

The applicable probability rules require that:

1. The probability of each of two events must be multiplied together

to find out the probability of both events occurring on a set of spins (e.g., lifetime use can win with a 2 if divorce is a 1).

2. The probabilities of two or more events be added together where any of those events may occur in order for a particular spinner to win (e.g., lifetime use can win with a 6 or a 4 if divorce must be a 1).

To be clear on these concepts, consider the political campaigns leading into the 2012 elections. If Mitt Romney has a .299 chance of being nominated by the Republican Party and a .411 chance of beating President Obama if nominated, then we multiply the two probabilities to figure that before the Republican convention, Mr. Romney has a 12.3% (.299 x .411) chance of becoming President. If you wanted to predict, instead, whether the person nominated by the Republican Party will be a conservative, as opposed to a moderate, you can add the probabilities of the nomination of each potential conservative candidate and that figure will represent the probability of a conservative nomination.

Applying probability theory to the issue at hand shows that sale value (a

50-50 split) would generate the most revenue, divorce the least. The chances that the \$300,000 sale value of the husband's interest will be greater than his value from a lifetime of use are 56% (i.e. the probability of a sale value of \$300,000 times the probability of \$200,000 for lifetime use (1 x .56 or 56%). The chance that the husband's value from sale will be greater than the value on divorce is 51% (1 x .51). The probability that the husband's value from lifetime use will be greater than the value on divorce is 61.78% (.22 x 1) + [.22 x .51] + [.56 x .51]).

In short, as Exhibit 1 shows, sale values will win 56% of the time over lifetime use and 51% over divorce. Thus, sale value will, over time, produce the most revenue regardless of what the innocent spouse's interest actually ends up being worth. If the IRS is interested in maximizing revenue, then it seems that it can dispense with other valuations, as the courts have done. Or maybe not?

Watch what happens when all three methods are examined in a three-way contest instead of in the one-on-one competition set forth in the exhibit. In a three-way competition, the husband's value on sale wins less than .30% of the time (.56 x .51 = .2856). The value from lifetime use wins less than a third of the time ([.44 x .51] + [.22 x .49] = .3322). The value from a divorce wins more than a third of the time (.49 x .78 = .3822).¹² In a three-way competition, then, the value on divorce calculations yields the most revenue for the government at 38.22% of the time, but only if all three methods are considered by the judge.

Conclusion

Given that a sale valuation might produce the least revenue over time if all three choices are considered, one might ask if the IRS chose the wrong path by not considering valuations other than one-half on sale, or whether it made a mathematical error. Either way, decisions regarding value in tax foreclosures would be better served if judges relied on more information—unless, of course, they prefer to use a coin. To this end, valuation professionals may want to give serious attention to valuations of innocent owner tax-liened property. ●

¹¹ Single digits represent multiples of \$100,000. The probabilities for each dollar value are displayed outside the spinners, except for the sale value, which is always \$300,000 (i.e., half of the full \$600,000 price).

¹² The statistical analysis can be found in Gardner, "Mathematical Games," *Scientific American* (March 1976).