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Where real estate and business appraisals converge

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I recently wrote about the semantic and valuation challenges of easements, where an ownership interest in real estate is encumbered with a right belonging to another. This is usually just about the real estate and the partial interest easement impact on value. But, there is a growing and challenging appraisal specialty that requires the combined experience and specialty education of real estate and business appraisers. Both are needed for the valuation of minority, partial interests in holding entities that own real estate and other assets that are gifted, sold or otherwise transferred.

For the past two decades there has been a large uptick in the transfer of partial interests, particularly between family members in partnerships or closely held businesses. The complexity of the concepts and valuation methods for minority fractional interests makes the preparation of Federal and State Income Tax Returns look mundane in comparison. The ability to create asset holding entities that are structured to restrict control and limit marketability of ownership interests can result in substantial value discounts and transfer tax savings. Although diminution in value is possible for majority intersts, most of the transfers involve minority positions. The tool is often used to gift or sell real estate and other assets in increments and gradually reduce the size of an estate for advantageous tax purposes. This is now regarded as a reasonable way to retain ownership and use of assets in a closely held, family-oriented vehicle. It is no longer regarded as merely a tax avoidance ploy.

There are several types of ownership commonly used for holding and transferring partial interests in undivided, closely held real estate or business assets. Direct ownership of real estate as tenants in common remains typical. But, most are family limited partnerships (FLPs); family limited liability corps (FLCs); and S or C corporations, with S corps enjoying many of the tax benefits of partnerships and avoiding double taxation.

The partial interest valuation process begins with a separate appraisal of the real estate market value as of the date of transfer. For an income generating property, the income approach to value is usually most appropriate, with periodic net operating income before debt service yield capitalized with a property discount rate that reflects an appropriate return on the entire debt and equity investment.

Here is where the valuation assignment becomes more interesting. The partial interest appraisal requires estimation of the value of the equity interest in the property net of liabilities. If the asset is owned by a corporation or partnership, then the balance sheet reflects all of the assets and liabilities of the entity, but these are not market driven. Real estate cost less depreciation is then "marked to market" by incorporating the independent real estate appraisal. Liabilities are subtracted from the assets to calculate net asset value (NAV), which is the starting point for the business valuation of the partial interest. NAV often includes more than just the real estate asset and any outstanding

debt.
The appraiser with business valuation experience is then charged with evaluating the type of property and its competitive market; ownership type; and partnership or shareholder agreements which each usually have restrictions on management of the holding entity and real estate as well as restrictions on the transferability of ownership interests. There are many factors that must be evaluated by this "hybrid" appraiser. Their impacts are first analyzed for a discount for lack of control penalizing a minority interest. Then, the impact of reduction in marketability is quantified. Finally, the discount rates are applied consecutively to the pro rata interest value to arrive at partial interest value.
A real estate appraisal is completed first. Its value as an undivided interest is then incorporated into a business valuation of the partial interest.
The cost, sales and income approaches are used, but transaction data is derived more from securities markets due to the lack of directly comparable real estate sales that reveal the sought after discount rates. All manner of trading prices in different investment market sectors are available and reveal differences in rates of return associated with the varying risks by type of property, vehicle, transferability and holding period. DCF analysis uses a built up method of risk free rate, real estate premium and subject specific risk premium estimated by comparison of available returns from REITS and closely held entities. Comparable partnerships are also examined to evaluate the percentage relationship between net asset value and partnerships transaction prices. These methods provide proxies for non-controlling interest value.
Yield premiums or discounts reflect higher or lower risk investment returns due to the risk associated with longer or shorter holding periods for similar instruments (eg. short versus long term government bonds measure illiquidity). These are translated into an appropriate discount for loss of marketability relative to the subject by converting the premium required for a longer term and therefore higher risk instrument into the discount rate required to price a lower risk, shorter horizon investment.
The cost of partitioning or forced liquidation in a non-controlling ownership scenario was a former favorite method of the IRS, but is no longer as prominent for estimating a discount rate. Among other issues, it fails to adequately reflect the impact of loss of control over the affairs of the holding entity or the alternative investment horizons that drive required return on investment.
A fine test of reasonableness of the estimated combined or separate discount rates for control and marketability is the evaluation of Tax Court decisions. These cases reveal discount rate decisions, their components and the rationale for using one valuation method rather than another. Use of court decisions requires evaluating the comparability of the circumstances of each case relative to the subject. The Service has often challenged partial interest discount rates and methods.
As the final step, the estimated discount rates for lack of control and reduction in marketability are consecutively applied to the pro rata value of the subject interest. This results in the partial interest value for tax purposes. Needless to say, discussions prior to the appraisal regarding property facts and assumptions, and a review of the partial interest appraisal report after completion, must be undertaken with the client and tax and legal advisors.
Although real estate appraisers and business appraisers usually do not each have the others' specific education and experience, that combination in one professional can be very useful to provide congruity and reasonableness between the separate valuations of the real estate and the partial interest. The valuation methods continue to increase in complexity along with popularity of these estate tax strategies. I have found this specialty and the combination of traditional real estate

appraisal and business valuation experience to be helpful to clients.

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