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Case Study: Partial interest valuation of real estate - by Marc Nadeau

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Partial Interest Valuation is a technique used by appraisers and other valuation professionals to estimate the value of a fractional interest in real estate. Fractional interests in real estate result from the owner's ownership of less than 100% of a given property. The technique involves the valuing of a fractional interest in real property with a discount factor being applied to that fractional interest. Reflective of what could be a number of factors including, but not limited to the nature of the property, the percentage or ownership and the management structure in place an appropriate "discount factor" is chosen by a valuation professional. Ownership of a partial interest in real property ownership can manifest itself in a number of forms. Those ownership forms include, but are not limited to: general partnerships, limited partnerships, REITs, joint tenancy, tenants in common, tenancy by entirety, family trusts and ownership of shares in a limited liability corporation.

The transfer or conveyance of a partial interest can arise from any number of events including: divorce, partnership dissolution, estate planning, donation or sale of a partial interest to an unrelated party and so on. In theory, partial interests are almost always worth less than their fractional value. For example, a \$1 million property owned by five different owners, each with a 20% interest, would in pure mathematical terms have a value of \$200,000 for each interest. That 20% interest, were it to be marketed or sold to another party would be considered a minority interest.

The nature of a minority interest is that it typically has the following characteristics:

- Lack of Marketability;
- Longer than typical Marketing time;
- Lack of Control;
- Limited or no ability to refinance the property; and
- Limited ability to influence decision-making policies.

Discounts associated with a partial interest can typically range from 20% to 60% of the proportionate value of the interest as it relates to the entire property. In the case of the \$200,000 fractional interest above, a discount factor would be applied to the fractional value.

The IRS perspective: The perspective or position of the IRS has frequently been that the discount applied to the fractional interest be limited to the actual cost of partitioning a property. The courts fortunately, have generally recognized that this is both unreasonable and illogical. The fact is that fractional interests for the most part have a very limited market appeal to the general marketplace with the range of appeal varying by the type of property and the percentage of ownership.

The IRS Training Manual for Appeals Officers in fact recognizes and cites several factors that could influence the size of the discount. The following factors are listed in the manual:

- The number of owners;
- The size of the fractional interest;
- The size of the tract;
- The use of the land;
- The availability of financing and finally;
- The cost of partitioning (dividing) the land.

Valuation Methodology: The following steps would be involved in valuing a partial interest:

1. Value the property in its entirety;
2. Calculate the value of the proportionate share in the property by taking the 100% value of the property times the percentage of property owned;
3. Determine an appropriate discount for the partial interest;
4. Calculate the value of the fractional interest by multiplying the value of the “proportionate share” times the discount rate.

Discount Rates ~ what are appropriate rates? Reflective of the fact that partial interests have very limited marketability there is certainly a lack of empirical market data that appraiser’s can draw from. One of the best benchmarks for determining an appropriate discount would be court cases.

The following is a summary of relevant court cases that involve partial interest valuations:

In the case of *Lefrak vs. Commissioner* the court did not consider fractional discounts as compelling evidence because security owners do not have the right to force partition (the shares were part of a corporate entity). However, the Court did allow a 30% discount for a minority interest and a lack of marketability.

In the case of the *Estate of Cervin vs. Commissioner* the Court allowed a 20% discount for a 50% undivided interest in a homestead and farm. The legal costs along with the time delays and discounts required by a prospective buyer were reasons for the granted discount.

The case of *Williams vs. Commissioner* involved the transfer of a 50% interest in 2,360 acres of rural land and its timber in Putnam County, Florida. The court found a discount of 44% to be reasonable. The discount factored in the cost of partitioning, the longer than typical anticipated marketing time and the lack of control.

The case of the *Estate of Baird vs. Commissioner* involved minority interests of timberland located in Louisiana. The plaintiffs specifically in this case were that of the Estate of John L. Baird and the Estate of Sarah W. Baird who were married at all pertinent times. John died on December 18, 1994 while Sarah died less than 1 year later on November 2, 1995. At times of death, John held a 14/65 interest while Sarah held a 17/65 interest in a trust that owned 16 noncontiguous tracts of timberland comprising 2,957 acres.

Both estates claimed a 60% discount on the tax returns with the plaintiffs mounting an impressive case that involved the testimony of two real estate appraisers that had extensive experience in valuing timberland as well as a third expert witness that had the experience of actually purchasing partial interests of like timberland. The appraisers, by product of analyzing actual partial interest sales of timberland arrived at discounts of 55% and 36% respectively while the timberland expert claimed that the discount should be 90%, while the written report prepared by the same expert claimed "at least a 55% discount". The Court found that a 60% discount was reasonable and supported.

Empirical Market Data ~ Partial Interest Sale: Locating actual sales of a partial interest is like finding a needle in a haystack. Given the lack of marketability combined with the difficulty of verifying such a transaction can leave appraisers very little to work with. Presented below is a recent example of a partial interest sale that the readers of this article may find useful in their own analysis of a partial interest:

Case Study ~ Sale of Partial Interest: This study involves the sale of a 1/5 interest in a property identified as Uncas Point Road located in Guilford, Connecticut. The parcel is a vacant, non-buildable waterfront parcel that contains .67 acres and was owned by 5 separate owners, each with an undivided 1/5 interest in the land. The value of the parcel is that it provides access to and has frontage along the harbor.

Established factual information of Case Study

Grantor: Jonathan Wallace;

Grantee: Carolyn Matthes;

Sale Date: July 1, 2010;

Sale Price: \$ 3,750 plus \$1,000 in assumed property taxes;

Volume/Page:801/340, Warranty Deed; and

Interest Purchased:1/5 fee simple interest.

Additional Facts for this Case

An independent appraiser appraised the property on September 24th, 2007 for \$75,000. With documented time adjustments the value of the property as of July 1, 2010 (the conveyance date) would have been \$52,500. \$52,500 divided by 5 = \$10,500. \$10,500 would be the value of a 1/5 interest before factoring in any discount. The discount factor derived from this sale would be 55%.

This appraiser interviewed both parties, both of who indicated that they were each acting in their own best interest. Ms. Matthes is a neighboring property owner who lives across the street from the parcel and is attempting to purchase the entire parcel in pieces in order to have a full, undivided fee simple interest in the parcel.

Recent Developments relating to Partial Interest Valuations

Several tax collection departments on the state level have taken the position that no discount would be allowed for a partial interest in an inherited property. This is true of a case in the State of Connecticut where several partial interest valuations were outright denied (after having passed muster on the initial estate valuation). No reason for the denial were given other than that the Department of Revenue Services person requested a meeting with the beneficiaries of the estate being passed on. This in my opinion is just a ploy to get beneficiaries to compromise on the tax liability of the estate.

Clearly a move on the part of the state revenue agencies to generate more income, perhaps to help offset a poorly managed fiscal mess that the state is presently experiencing.

This position is contrary to recent case law, contrary to empirical data and contrary to simple logic. This appraiser recommends retaining a qualified professional or professionals, including that of an attorney who is versed in estate valuation matters.

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