



VALUE ADDED™

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Valuing Fractional Interests in Real Estate

Title to real estate may be held in a variety of ways – as a single individual, joint tenancy with right of survivorship, or a fractional interest such as tenant-in-common. In the case of a co-tenancy, the valuation of a fractional interest goes beyond a proportionate interest in the property as a whole. For example, is a 50% tenant-in-common interest worth 50% of the total value of the property? If not, how much less and why? It is the determination of the relationship between the value of the fractional interest and the pro rata portion of the whole that is the subject of this article. It is appropriate for business appraisers to analyze this question since the fractional interest bears more resemblance to our traditional work than that of the real estate appraiser.

The definition of a fractional interest in real estate appears to vary widely in the popular literature. Some authors use a narrow definition which encompasses only the direct ownership of real estate through some type of joint ownership arrangement. Other authors expand the concept to include fractional interests owned indirectly with an intervening layer of ownership, such as a corporation, general partnership, or limited partnership. The later approach often seems to make the issue of direct ownership of a fractional interest seemingly another valuation question on the same "laundry list" as indirect ownership. This article will focus only on the direct form of ownership because the valuation issues are, in fact, different and that confusion between direct and indirect ownership of a fractional interest can lead to serious errors.

Rights of Ownership. Understanding the differences between the rights of ownership in a fractional interest that is directly owned and one that is created by indirect ownership is essential in the valuation process. Owners of business and real estate interests have varying rights.

The owner of a 100% interest in real estate has rights similar to those of the controlling shareholder of a corporation. The owner of a direct fractional interest in real es-

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Defining the Valuation Assignment

Confusion and ill will can often result between a business appraiser and client when the appraisal delivered is not what the client thought he was getting. For this reason, it is extremely important that the first step in any appraisal is to clearly define the valuation assignment. Responsibility for a clear definition is shared between the appraiser and the client.

The following factors must be defined before the appraisal begins:

- **Definition of value.** The definition of value must be clearly defined because it will effect the selection of valuation methods used, and thus the final appraised value. Most business appraisals will be at fair market value (defined as the amount at which property would change hands between a willing

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tate, however, regardless of the percentage of fractional ownership, has a different group of ownership rights and responsibilities. Any owner of a fractional interest in real property generally has the following rights:

- The right of partition
- The right to a pro rata share of income
- Veto power over decisions about use of the property

State law ultimately determines the exact bundle of rights available to the holder of the interest. (It is incumbent on the business appraiser to be certain that he or she is familiar with those laws and applicable court decisions whenever an appraisal is performed.) The fractional form of ownership provides protections not found in the corporate or the limited partnership structure. The general partnership may be more similar to the fractional interest in the protection afforded the owner of the interest, however, once again, state law will govern. The holder of the fractional interest encounters additional risks or constraints. Since any co-owner, regardless of the percentage of ownership, has the right of veto over use of the property, it is more difficult for another owner to mismanage it or to take advantage of a favorable opportunity for sale or development.

Discounts for Fractional Interests.

Since the owner of a fractional interest does not have complete control over the property, many people believe that some decrement to value from the pro rata value is appropriate. The United States Tax Court has recognized, most recently in the following cases, that discounts from the pro rata market value of the underlying (fee simple) property may be appropriate.

- *Bonnie I. Barge v. Commissioner* T.C. Memo 1997
- *Samuel J. LeFrak and Ethel LeFrak v. Commissioner* T.C. Memo 1993-526
- *Louis F. Bonner, Sr. v. United States*, Fifth Circuit Court of Appeals

The discount is derived from the inability to control the disposition or other use of the property and for the illiquidity of the fractional interest. In a broad sense, each of these discounts is similar to those found in the analyses of limited partnership interests and stock in closely held corporations. The differences are crucial, however, because they determine the applicability of the evidence used to determine the discount. The Tax Court has explicitly recognized this in its recent decisions.

Recent Decisions. The *Bonner* case affirmed the existence of a discount for a fractional interest by acknowledging that the parts are worth less than the whole. The court concluded that a 30% discount was appropriate for the minority interest (20%) and for lack of marketability (10%). *LeFrak* required an analysis specific to the facts at hand in determining the discounts rather than references to prior court cases.

Barge is most instructive in that it allowed the discount required and held that the discount be calculated in a case-specific manner, but then set forth a methodology for doing so.

The Right of Partition. The owner of shares in a corporation or a limited partnership interest does not have direct access to the underlying assets of the business entity. The owner of a fractional interest in real estate possesses the right of partition, which may create a direct or indirect avenue for liquidity of the fractional ownership interest by causing a sale of the property or a realignment of the ownership. In other words, partition is a legal process whereby the owner of fractional interest compels a change in ownership or use of the property.

If there happens to be an ownership problem, partition may be the only solution. It should not be viewed as a step taken lightly or one that automatically and inexpensively solves a problem. Partition may not be timely because it can involve court proceed-

ings, which may be contested. The costs of partition include legal fees, surveys, and possibly studies to define the best use of the property. Furthermore, it does not guarantee that the owners of an undivided interest will achieve the tax or business objectives they desire or that they will receive cash. Finally, if the court orders the property sold, the owners must deal with the reality that there is an element of compulsion, which may reduce the sales price of the property.

The right of partition does not automatically result in a sale of the property. In most cases, there are five possible remedies a court can impose.

- The court may divide the property between the tenants, thereby giving each co-tenant a sole tenancy in the portion allocated by the court.
- The court may allow one tenant to buy out the interests of the other tenant(s).
- The property may be sold and the proceeds distributed in proportion to their ownership interests.
- The property may be divided into unequal portions (based on value) with any inequities resolved by the exchange of money.

Finally, a court may require equal use or access to the property without changing ownership. This might occur with a unique property like a beach or mountain home.

Valuation Considerations. The valuation of fractional interests requires a number of considerations. Since there is limited empirical evidence, there is ample room for the exercise of appraiser judgment in the context of the facts and circumstances of each case. Among the more important considerations are the following:

- The cost of partition and the availability of that remedy under state law or judicial decision. Partition is an expensive process. What is the willingness and capacity of the owners to engage in such a proceeding?

- What is the probability of a change in use of the property and how significant is a dispute over use likely to be in affecting economic returns?
- What is the size of the fractional interest? Even a small interest has relevance, whether nuisance or otherwise.
- What is the history of sales of comparable interests and how were they priced?
- Is the property physically divisible so that each co-owner could receive an equitable share?
- Is a co-owner(s) financially able to purchase the interest(s) of the other owner(s)?
- Was the property subsequently sold and, if so, at what price?
- Are future operating cash flows expected to be positive or negative? Are further contributions required for improvements or maintenance?
- What is the general illiquidity of the fractional interest?

The Market and Income Approaches.

The objective is to value the undivided fractional interest in real estate. Therefore, two general approaches—market and income, should be discussed. Under the market approach, indications of value are derived from an analysis of the sale of similar or identical interests in the property or other property in the marketplace.

Most properties rarely have the sale of a fractional interest. Furthermore, there are few studies which purport to track the relationship between the price of a fractional interest and the pro rata value, which gives the business appraiser the ability to calculate a discount. Given the paucity of empirical data, an alternative approach is often needed.

Under the income approach, an indirect method is employed which incorporates the future economic benefits of ownership based upon the risks and rewards of those interests. Any decrement to value between the value determined and the pro rata share of

proceeds from the sale of the property as a whole represents the “discount” required by the market to induce a buyer to purchase and a seller to sell.

Conclusion. At its essence the owner of fractional interest faces a similar dilemma as does the owner of a minority interest in a corporation. The interest does not have control and is illiquid. The appraiser’s dilemma, however, is that all of the empirical evidence used to support the magnitude and existence of minority interest marketability discounts is not relevant to a fractional interest in real estate. The citation of restricted stock studies, IPO studies, and numerous court cases is not germane. What is relevant to any investor/owner and business appraiser are the following:

- What is the property, as a whole, worth today?
- How fast will it grow in value?
- What are my required rates of return until I achieve liquidity?
- What are the interim cash flows until liquidity is achieved?
- What kind of circumstance will cause liquidity to occur?

As with stocks and limited partnership interests, there are many answers to the final question. However, unlike these other interests, the right of partition compels something to happen. For this reason, the IRS has concluded that the cost of partition is the basis for establishing any discount.

The Tax Court in *Barge* has affirmed a simple and economically sound approach to valuing a fractional interest in real estate. Briefly, the court’s procedure was the following:

- Establish fair market value of the property as a whole at the valuation date using appropriate real estate, forestry, and/or mineral experts.
- Determine the likely time required for achieving partition based upon state law. There could be an alternative for liquidity, such as a sale. In any event, this establishes a future date for attaining liquidity.

- Determine the growth rate in fair market value of the property. This permits the calculation of a terminal value at the future date when liquidity occurs. Once again, a future sale could determine the future value.
- Determine interim cash flows between the valuation date and the terminal date. Positive cash flows could come from rentals, mining or timber cutting. Adverse cash flows would be the cost of partition, taxes, etc.
- The interim cash flows and the terminal value would be discounted to the valuation date at an appropriate required rate of return.

There are numerous assumptions required for this process. Yet, it is far more objective than the application of irrelevant evidence. Second, since there are few arms’ length transactions of fractional interests, there is no “experience” upon which to base the valuation and the implicit discount. Most importantly, it reflects the thinking, either explicitly or implicitly, of real world investors.

The courts are requiring fact specific analyses supported by relevant evidence. The tools are available. Give us a call if we can help you. ♦

Defining the Valuation Assignment

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seller and a willing buyer when neither is under compulsion and when both have reasonable knowledge of the relevant facts), but depending on the circumstances, state statutes or other factors may require a different definition of value, such as fair value or liquidation value.

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- **Purpose of the Appraisal.** The purpose of the appraisal may effect the time perspective, orientation, or any number of other details that relate to the appraisal value, and it aids in the reader's formation of an opinion about the reasonableness of the conclusion.
- **Type of Ownership Interest.** The type (common stock, preferred stock, option, etc.) and quantity of interest being valued must be specified. A business ownership interest that represents a controlling interest in a company (more than 50% of the outstanding common stock) is worth more than an interest that represents a minority interest. Other factors to consider include restrictions on the business interest, ownership of remaining shares of stock, and whether stock being valued consists of existing or newly issued shares.
- **The Effective Date of the Appraisal.** Every valuation assignment must have a specific "as of" date. For historical appraisals, the appraiser must be careful to use information that he believes would have been available had the appraisal been performed at the effective date.

Also required in defining the scope of the report is to specify the levels of

valuation to be performed. There are three levels of appraisal recognized by the American Society of Appraisers in ASA Business Valuation Standard BVS-I (*General Requirements for Developing a Business Valuation*), #II:

- **Appraisals** - expresses an "unambiguous opinion" as to the value of the specific business interest, which is based on all conceptual valuation approaches that the appraiser deems to be relevant to the valuation.
- **Limited Appraisals** - expresses an estimate of the value of a business interest which lacks the rigor involved in performing a full appraisal.
- **Calculations** - provide an approximate indication of value based on the performance of limited procedures agreed upon by the appraiser and the client.

The above factors relate to the specific appraisal assignment for which the appraiser is being hired. They were designed to roughly correlate to "audited," "reviewed," and "compiled" financial statements. It is equally important, however, that the client and appraiser define the nature of their rela-

tionship. Appraisal documentation should define exactly who the client is and who the appraiser is. The appraiser should be an appraisal firm rather than an individual appraiser, because retention of an appraisal firm provides security and continuity in the event that an individual appraiser becomes unavailable to perform the appraisal. The appraisal report should clarify that there are no existing relationships between the client and appraiser that would prevent the appraiser from rendering an unbiased opinion. The fee arrangement should be specified in a signed letter between the appraiser and client, and the appraisal report should clearly state that the appraiser's compensation is not contingent upon the results of the appraisal conclusions. The form of the report (i.e., "stand alone" report, oral report, or letter report) should also be specified. Finally, a timetable for delivery of the completed appraisal should be agreed upon at the outset of the appraisal assignment.

These issues are important, not only for sound valuations but for the mutual understanding of every involved. As a user of business appraisals, insist that each issue raised by this article be clarified before analysis is begun. ♦

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