Revisiting Valuation of Real Estate Partial Interests: Recent Case Studies

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The Appraisal Journal- Volume LXIX (October 2001)

Abstract

Valuing partial interests, such as common tenancies, is one of the more difficult assignments in appraising property interests. There are usually few comparable sales, a myriad of complex issues revolving around the rights of the owner, and a likelihood of litigation. While the Tax Court generally supports substantial discounts, the Internal Revenue Service consistently maintains that the only allowable discount is the direct cost of partitioning the property. In this article, we cite three cases in which the appraiser discounted the value of the partial interest by using the time and costs of partitioning the property and the cost of marketing the interest.

Valuing partial interests, such as common tenancies, is one of the more difficult assignments in appraising property interests. There are usually few comparable sales, a myriad of complex issues revolving around the rights of the owner, and a likelihood of litigation. Most studies indicate that partial interests should be discounted from their pro rata portion of the value of the property as a whole. Valuation of partial interests often relates to an issue of estate or gift tax. While the Tax Court generally supports substantial discounts, the Internal Revenue Service consistently maintains that the only allowable discount is the direct cost of partitioning the property. In this article, we cite three cases in which the appraiser discounted the value of the partial interest by using the time and costs of partitioning the property and the cost of marketing the interest.

In an estate return, the fair market value of a partial interest in real property is determined as of the date of the death (or six months later). For a gift tax return, it is determined at the date of the gift. The appraisal considers the value that a knowledgeable third party would pay in cash or cash equivalents, and discounts are based on the expectations of a reasonable investor. Since the timing and costs of a partition suit and a sale are uncertain, an investor purchasing an undivided interest in real estate would be expected to discount the pro rata value of a fee simple interest based on the costs of a partition suit and sale; the opportunity cost of capital invested in the interest; and the uncertainty of the timing, costs, and outcome.

Most studies on discounting partial interests have relied on developing discounts based on the sales of real estate or corporate securities. The Tax Court has held that since many real estate interests can be partitioned, unlike security ownership interests, discounting should represent the costs involved in the partitioning process. This article illustrates a methodology for determining discounts based on the time and cost of the legal process to physically and economically partition and sell a real property. Other methods of determining the discount for properties that cannot be partitioned, such as an office building or regional shopping mall, are also discussed.

Partial interests are created in a variety of situations such as gifting an interest to a family member, a joint purchase by a husband and wife, or the sale or gift of an interest to an unrelated party. A potential purchaser of a partial interest can expect difficulty in reaching an agreement regarding the management and sale. Additionally, there is a significant probability that the purchaser will face hostility from their co-owners. Lack of control and marketability are the key factors that reduce the value of partial interests in real estate.

One method of dividing the property among common owners is partitioning. This method separates or hypothetically values the interests of undivided owners. The cost to partition a property is based on the attorney's fees and related costs and the time spent waiting to obtain a marketable partitioned interest, which is considered a loss of potential income to the purchaser. The potential loss of income to the seller is based on an investor's estimated opportunity cost of capital. The average time to partition the property is determined by an analysis of property partition cases. Any income that will be received during the partitioning or sale process, such as rental income, must be used to offset the investor's opportunity cost of capital. The time and cost are the primary determinants of the lack of control discount for an undivided interest.

The lack of marketability discount is measured by the time and cost to sell the property interest once it has been partitioned. The cost of sale discount consists of typical real estate commissions and closing costs in the local market. The time to sell a discount is based on the estimated time to sell the real property, which is typically indicated by the real property appraiser. The time to sell and the opportunity cost of capital are used to determine the investor's opportunity cost of selling the partitioned interest.

In the case of properties that cannot be reasonably partitioned, such as office buildings or regional shopping malls, the appraiser must rely on proxies for determining the discount. These proxies consist of discounts from selling pre-IPO common stocks and secondary market discounts for sales of real estate limited partnership interest studies. The lack of control discounts, the marketability discounts based on brokerage commissions, and the time to sell can range from 20% to 46%.

Court Findings

Since the IRS attempts to severely limit discounts on partial interests, many larger estates must be litigated. In the case of LeFrak v. Commissioner, [1] the Court did not consider fractional discounts from corporate securities as compelling evidence because security owners do not have the right to force partition. However, the Court did allow a 30% discount based on the factors of minority interest and lack of marketability. In 1998, Hand and Wald [2] explained court findings related to fractional interests in real estate. Three major circumstances that support minority discounts are difficulty in managing the property as a whole, extra costs to market fractional interests in a limited market, and the time delay involved in their disposal.

Hand and Wald also outlined specific court findings. In the Estate of Cervin, [3] the Court allowed a 20% discount for a 50% undivided interest in a homestead and farm. The legal and appraisal costs, as well as time delays and discounts required by a buyer, were reasons for the discount. LeFrak v. Commissioner allowed a 30% discount for fractional interests in several apartment and office properties. Separate discounts for minority interests and lack of marketability were allowed by the Court. For the Estate of Barge, [4] which represented a minority interest in timberland, a 25% discount was allowed by the Court.

In the Estate of Williams case, [5] the Court allowed a 44% discount. It said that the inability to find comparable sales supported the contention of a limited market for partial interests. In fact, Humphrey and Humphrey [6] concluded that fewer than one in 10,000 recorded sales in the U.S. involved the sale of an unsyndicated partial interest in real estate. The Court also affirmed that the broad business analysis approach used by the business appraiser [7] in the case was an appropriate method to determine the discount.

Case 1: Estate of Williams

One of the interests that was valued in the Estate of Williams case consisted of a 50% interest in 2,360 acres of rural land and its timber in Putnam County, Florida--known in the case as Parcel 4. The 50% interest was transferred in 1980 to Mr. Robert Driggers. The 100% fee simple interest was appraised by a real property appraiser at $1,096,000 as of the date of transfer. The pro rata share of value of the 50% interest in the land would, therefore, be $548,000.

The costs to partition a partial interest in real estate include the direct legal fees and the opportunity cost based on the time required to complete the partition process. The attorney's fees for a complex case such as the Williams Case were estimated at $40,000, based on a study by Clark, Boardman, and Callaghan. [8] The discount for the time to partition is based on a reasonable rate of return that could be expected by an investor in a large tract of unimproved land. A conservative risk premium above the coupon rate on a long term U.S. Treasury bond would be at least in the range of 3% to 5%.

Since the U.S. Treasury Bond coupon rate at the end of 1980 was 12.4%, the appraiser determined a reasonable expected rate of return for an investor in this type of property would be 16% per year. Based on the average time to partition, 17 months, [9] the total discount for the time to partition was 23.23% from the pro rata value of $548,000, or $127,000. This discount was added to the estimated attorney fees of $40,000 for a total discount of $167,000, which was then rounded to a total discount of 30%, or $164,400 (for lack of control based on the remedy of partition). The value of the partial interest before the marketability discount was calculated at $383,600 after the lack of control discount.

The real property appraiser estimated that marketing time for similar large parcels was approximately nine months. The discount for the time to sell was estimated at 12%, which equates to a 16% annual return for a nine month time period. The sales commission and related closing costs for an unimproved parcel of land in the area were estimated at 10%. The time and cost to sell discounts were rounded to 20% by the appraiser. The 20% discount was then applied to the $383,600 partial interest estimate totaling $76,720.

The final value of the interest, after the lack of control and marketability discount, was $306,880, which was then rounded to $307,000. Note that the 30% lack of control discount and the 20% marketability discount are sequential and not additive. Therefore, the total of the discounts was $247,000--44% of the pro rata value of the fee simple interest. This discounting method is summarized in Table 1.

Table 1 **Estate of Williams**

Description	Discount	Amount
Appraised value of real property fee simple interest		$1,096,000
Pro rata 50% interest in real property and timber	50%	548,000
Less cost to partition discount		
Attorney’s fees		$(40,000)
Less time to partition discount (17 months)	22.67%	(124,232)
Total value after cost and time to partition discount		$383,768
Rounded value after lack of control discounts	30%	$383,600
Less cost of selling (COS)		
Real estate selling cost (10%)	10%	$(38,360)
Time to sell (9 months)	12%	$(46,032)
Total value after lack of control and cost to sell discounts		$299,208
Rounded value after lack of control and marketability discounts	20%	$306,880
Final value of interest (rounded)		$307,000
% Discount		44.0%

Case 2: Neighborhood Shopping Center

The Neighborhood Shopping Center Case is based on a valuation conducted by Business Valuation, Inc. (BVI). The shopping center contained 30,000 square feet of net rentable area, and the net operating income was $360,000. The resulting valuation by the real property appraiser of the 100% fee simple interest was $3 million based on a capitalization rate of 12%. The appraisal assignment in this case was to value a 50% undivided interest rate in the shopping center that had been given to a relative of the grantor. The pro rata share of value of the 50% interest rate in the shopping center was $1.5 million. The attorney's fees to partition the shopping center were estimated at $40,000. [10] The lack of control discount, based on the partition, consisted solely of the attorney's fees because the cash flow to the investor from the shopping center offset any loss of opportunity cost during the time to partition. The value of the partial interest was calculated at $1,460,000 after the lack of control discount, but before the marketability discount.

The marketing time for the subject was estimated at one year by the real property appraiser. No discount was taken for the time to sell due to the shopping center income during the sales period. For a neighborhood shopping center of this size in this area, the sales commission and related closing costs were estimated at 5%. The 5% discount was then applied to the partial interest value, $1,460,000, totaling $73,000. The final value after the interest, lack of control, and marketability discounts was $1,387,000. The total of the discounts equaled $123,000--7.5% of the pro rata value of the fee simple interest. This discounting method is summarized in Table 2.

Table 2 **Neighborhood Shopping Center**

Description	Discount	Amount
Appraised value of real property fee simple interest		$3,000,000
Pro rata 50% interest in real property	50%	$1,500,000
Less cost to partition discount		
Attorney’s fees		$(40,000)
Less time to partition discount (12 months)	0%	$0
Total value after cost and time to partition discount		$1,460,000
Value after lack of control discounts	2.67%	$1,460,000
Less cost of selling (COS)		
Real estate selling cost (5%)	5%	$(73,000)
Value after lack of control and marketability discounts	5%	$1,387,000
Final value of interest		$1,387,000
% Discount		7.5%

Case 3: Residential Lots

The Residential Lots Case is another case based on a valuation performed by BVI. This assignment involved the appraisal of three residential lots where total fee simple value equaled $48,000. The appraisal assignment was to value a 50% undivided interest in the three lots that were given to a relative of the grantor. The pro rata share of value of the 50% interest in the lots totaled $24,000. The attorney's fees to partition the lots were estimated at $10,000, based on a simple partition case from the Clark, Boardman, and Callaghan study. The time to partition the center was estimated to be 12 months, and the opportunity cost of capital for an investor in the vacant land was estimated at 10%. Based on the time to partition, 12 months, the total discount was 10% from the pro rata value of $24,000, or $2,400. This discount was added to the attorney fees for a total discount of $12,400--51.7% of the pro rata value for lack of control based on the remedy of partition. The value of the partial interest was calculated after the lack of control discount, but before the marketability discount, at $11,600.

The appraiser of the real property estimated that marketing time for the lots at approximately five months. The discount for time to sell was estimated at 4.2%, which equates to a 10% annual return for the five month time period. The sales commission and related closing costs for unimproved lots in the area were estimated at 10%. The time and cost to sell discounts totaled 14.2%. That discount was then applied to the $11,600 value, after the lack of control discounts, thus totaling $1,647. The final value of interest after both discounts equaled $9,953, which was then rounded to $10,000. The discounts totaled $14,000--58.3% of the pro rata value of the fee simple interest. This discounting method is summarized in Table 3.

Table 3 **Residential Lots**

Description	Discount	Amount
Appraised value of real property fee simple interest		$48,000
Pro rata 50% interest in real property	50%	$24,000
Less cost to partition discount		
Attorney’s fees		$(10,000)
Less time to partition discount (12 months)	10%	$(2,400)
Total value after cost and time to partition discount		$11,600
Value after lack of control discounts	51.7%	$11,600
Less cost of selling (COS)		
Real estate selling cost (10%)	10%	$(1,160)
Time to sell (5 months)	4.2%	$(487)
Value after lack of control and marketability discounts	14.2%	$9,953
Final value of interest (rounded)		$10,000
% Discount		58.3%

Non-Partionable Properties

Most office buildings and regional shopping centers cannot be reasonably partitioned. In such cases we must rely on proxies of partial interests in real estate partnership sales and corporate pre-IPO sales. Hanford's [11] interviews with a leading buyer of partial interests determined discounts may range from 30% to 40% for a typical real estate partnership. Thompson and Dagborjartsson [12] discovered real estate partnership discounts in the secondary market average 44% to 46%.

Many authors have used the discounts for restricted corporate securities as a proxy for the appropriate discount for partial interests in real estate. Thompson and Dagbjartsson cite a 1992 study by Merrill Lynch [13] of 142 transactions in which purchasers were seeking control of corporate stocks. They inferred an average discount of 29.1% for lack of control. Webb and Lunn [14] discuss studies that show discounts for restricted stock sales of 20% to 40% and discounts of pre-IPO trading of 43% to 45%.

Percentage interest and other restrictions that affect the lack of control can be used in determining the lack of control discount. Using the proxy approaches cited above, an appraiser could reasonably choose a lack of control discount ranging from 20% to 46%. The level of commissions and the time to sell such an interest should be used to determine the lack of marketability discount. This discount should range from 5% to more than 20% based on the estimated time to sell the interest and the commission for partial interest sales. [15]

Conclusions

The process of valuing partial interests in real estate is complicated by a lack of comparable sales and the likelihood that the results may be challenged by the IRS. The first of the three cases discussed in this article present a methodology for discounting partial interests that was accepted by the Tax Court. The total discount is based on lack of control and marketability discounts grounded in the parties' right to force partition of real property. The additional cases illustrate the treatment of an income producing property and the valuation of a low-priced property. However, for a property such as an office building or regional shopping center, discounting must be based on experience with sales of securities. The cases illustrate that the amount of the discounts can vary widely, from 7.5% to 58.3% in these cases, and each interest must be carefully evaluated to consider the varying circumstances in each situation.

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(1.) LeFrak v. Commissioner, TCM 1993-526.

(2.) K. E. Hand and E. M. Wald, "Court Again Rejects Limitation of Fractional Discounts," Trusts and Estates (August, 1998): 69-72.

(3.) Estate of Cervin, TCM 1994-550.

(4.) Estate of Barge, TCM 1997-188.

(5.) Estate of Williams, TCM 1998-59.

(6.) W. H. Humphrey and B. B. Humphrey, "Unsyndicated Partial Interest Discounting," The Appraisal Journal (July 1997): 267-274.

(7.) Business Valuation Inc. performed the appraisal for this litigation.

(8.) Based on the 1996 study of time and cost to partition in Clark, Boardman, and Callaghan Estate and Personal Financial Planning.

(9.) Ibid.

(10.) lbid.

(11.) L D. Hanford, "The Market Value of Partial Interests in Real Property," The Appraisol Journal (October 1989): 460-465.

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(13.) Merrill Lynch. Merglistat Review 1991 (Schaumburg, IL: Merril Lynch, 1992): 90.

(14.) D. A. Webb and G. E. Lunn, "Would You Buy an Undivided Interest," Valuation Strategies (September/October 1998): 26-36.

(15.) For periods substantially greater than one year time to sell and cost to sell discounts must reflect time value of money.

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