

VALUE ADDED™

Post Office Box 2392
Darien, Connecticut 06820-0392
Telephone/Fax: (203) 325-2703

NYNJCTbizval.com
info@NYNJCTbizval.com

Post Office Box 15
Shelter Island Heights, New York 11965
Telephone/Fax: (631) 749-1246

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 estate, 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

(Continued on Page 2, Column 1)

Top Ten Things Every Attorney Should Know About Business Appraisal

It seems as if just about everything in American life is now condensed in a "top ten" list. Not to be left out of the trend, we have compiled our own "top ten" list - the "top ten things every attorney should know about business valuation." While a few of the items on the list might seem obvious, to many they are not.

1. **Define the Project.** In order for the appraiser to schedule your work, set the fee and understand your client's specific needs, the attorney needs to provide some basic benchmark information, such as: describe the specific ownership interest to be appraised (number of shares, units, bonds); understand the "level of value" for the interest being appraised; specify the valuation date, which may just be current, or may be a specific historical date; describe the purpose of the

(Continued on Page 3, Column 3)

IN THIS ISSUE

Valuing Fractional Interests in Real Estate	1
Top Ten Things Every Attorney Should Know About Business Appraisal	1

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.M. 1993-526
- *Louis F. Bonner, Sr. v. United States*, 5th 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.

Court 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 proceedings, 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 prop-

erty. 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 or 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. ♦

Top Ten

(Continued from Page 1)

- appraisal (inform the appraiser why your client needs an appraisal and how the report will be used).
2. **Understand the Standard of Value.** There are different standards of value for appraisals under certain circumstances and in different jurisdictions. Typical tax compliance appraisals are based on "fair market value," certain jurisdictions require "fair value" in dissenters' rights cases; and "liquidation value" may be appropriate in certain cases.
 3. **Involve the Appraiser Early On.** Even in straightforward buy-sell agreements, family limited partnerships, or corporate reorganizations, it is usually helpful to seek the advice of the appraiser before the deal is set, to see if there are key elements of the contract document that could be modified to provide a more meaningful appraisal to your client.
 4. **Distinguish Between a Business Appraisal and a Real Estate Appraisal.** Many of the corporate entities appraised either own or rent the real estate where the business is operated. For a successful operating business, the most meaningful valuation is typically based on some measure of capitalized earnings, rather than the value of the underlying real estate. However, one should recognize that some businesses, due to the nature of their operations, are characterized more by their underlying assets, and less so by their earnings

power. This is true for asset holding entities, and for some older family businesses with marginal earnings but with appreciated real estate on the books. Many business appraisers are not asset appraisers, but may need to consider a qualified real estate appraisal in the business valuation process.

5. **Establish a Reasonable Time Frame.** Your client's business appraisal is a custom piece of work and he may not have immediately available all the information requested at the outset of a valuation assignment. Typically, a valuation project takes several weeks to complete. That can be accelerated to meet special needs, but it is usually a good idea to avoid rushing the production of a complex appraisal project.
6. **Insist on an Appraisal Firm with Experience and Credentials.** Each business appraisal is unique and experience counts. Most business valuation firms are generalists rather than industry specialists, but the experience gained in discussing operating results and industry constraints with a broad client base gives the appraisal firm lots of ammunition to understand

your client's special situation. Credentials do not guarantee performance, but they do indicate a level of professionalism for having achieved and maintained them.

7. **Know the Primary Business Valuation Methods.** Business valuation is an art as well as a science and appraisers will utilize and give different weights to various valuation methods as they suit the particular needs of an assignment. Key methods typically utilized include the transactions method; underlying net asset value method; capitalization of earnings method; guideline company method; and discounted cash flow.
8. **Consider the Appraisal as a First Line of Defense.** A well-reasoned and documented appraisal report serves as an indication of the seriousness and professionalism with which you address your client's needs. Having an independent appraisal in a transaction situation provides a level playing field for negotiations in good faith on both sides. For tax-compliance cases, the appraisal serves notice to the other side that they need to be equally prepared to support their opinion of value.

9. **Litigation Support Issues.** The business appraiser cannot serve as advocate for your client, but it is always helpful to have an experienced business appraiser available for expert opinion testimony. In addition to providing a well-reasoned and documented report, the appraiser must be able to articulate the reasonableness of valuation and investment conclusions to the court and be able to deal with intensive cross examination.

10. **Expect the Best.** In most cases, the fee for appraisal services is nominal compared to the dollars at risk and the marginal cost of getting the best is negligible. You can help your appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best appraisers have the experience and credentials described above, but recognize the delicate balance between art and science that enables them to interpret the qualitative responses to due-diligence interviews and put them in a stylized format that quantifies the results.

Our firm has the experience and credentials to handle your client's appraisal assignment. ♦

This publication is intended to provide accurate and authoritative information on the subject matter covered. It is distributed with the understanding that the publisher and distributors are not rendering legal, accounting or other professional services and assume no liability whatsoever in connection with its use.

J.L. Pierson, AM

J.L. PIERSON & CO. LLC

P. O. Box 2392 • Darien, CT 06820-0392

P. O. Box 15 • Shelter Island Heights, NY 11965

NYNJCTbizval.com