discounts on UNDIVIDED INTERESTS IN REAL ESTATE

VALUATION PROFESSIONALS MUST ADJUST THEIR METHODS AS THE PROCESS FOR DETERMINING DISCOUNTS ON UNDIVIDED INTERESTS IN REAL ESTATE EVOLVES.

a "how to" approach

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There is an abundance of good writing on this subject. Much of it has appeared in this very publication.[1] It is not the objective of this article to repeat the previously presented wisdom but to provide some practical guidance on how to exercise it. For the valuation analyst this article is a "how to" manual. For attorneys and other advisors it will provide guidance in evaluating a valuator's qualifications and reports.

Undivided Interests Defined

Undivided interests are very common and appear in many estates. They routinely result from a senior family member passing away with only one asset (a piece of real estate) and multiple heirs. One solution is to leave each heir a fractional interest in the real estate. Undivided interests can originate in other ways of course, but this is a pretty common scenario and serves the illustrative needs of this article.

Technically, undivided interests can be defined as "a direct interest of less than 100% in real property". "Direct" refers to the fact that there is no intermediate entity (e.g., a partnership) holding title to the land. A tenancy-in-common is an example of an undivided interest. The owner of such an interest owns literally his or her percentage of the whole and not an identifiable or legally described section, acre, floor, room, entrance, easement, shady corner or anything else that can be readily broken off and sold. The percentage of ownership generally only comes into play upon liquidation. An interest of greater than 50% does not bestow "control" on the owner and as such the concept of majority and minority interests are irrelevant.

Examining the "rights" of such ownership interests (in no particular order), one can see that even elements that initially appear to be *positive* may actually prove to be *negative*:

- The right to occupy.
- The right to operate or share equally in all decisions.
- Unlimited and unshielded liability.
- No liquidity.
- No ability to finance.
- The right to partition.

The impairments to value are obvious. There has never been an argument over whether an undivided interest in real estate should be valued at a discount from its pro rata share of the fair market value of the property taken as a whole. The arguments arise over the magnitude of the discount.

Tax Court Guidance

As common as these interests are, it is not surprising that there is an abundance of U. S. Tax Court cases involving them. The cases demonstrate a need for more sophisticated methodology. This article will refer only to cases that serve to illustrate specific "dos" and "don'ts".

The IRS attempted to draw a line in the sand with TAM 9336002, in which

EXHIBIT 1
Analysis of Uncontested Partition and Related Discount from Full Value

Year 1		
Cash Inflows:		
Projected annual rental income (per appraiser)		$28,000
Cash Outflows:		
Projected annual operating expenses (per appraiser)		6,500
Appraisal costs		1,500
Survey fees		1,000
Legal fees related to partition proceedings		15,000
Total Cash Outflows		24,000
Net Cash Inflow Year 1		4,000
Year 2		
Cash Inflows:		
Projected annual rental income (per appraiser)		28,000
Value per appraisal	400,000	
Appreciation during proceedings (3% over two years)	24,360	
	424,360	
Discount related to judicial sale (10%)	(42,436)	
		381,924
Referee's fees (6%)		(22,915)
Total Cash Inflows		387,009
Cash Outflows:		
Projected annual operating expenses (per appraiser)	6,500	
Legal fees related to partition proceedings	10,000	
Environmental remediation	25,000	
Total Cash Outflows		41,500
Net Cash Inflow Year 2		345,509
Present Value of Year 1 Net Cash Inflow (discounted @11%)		3,604
Present Value of Year 2 Net Cash Inflow " "		280,422
Present Value of Proceeds from Partition		284,026
Full Value of Proceeds		400,000
Amount of Discount arising from partition		115,974
Percentage Discount arising from partition		29.0%

it asserted that: "The amount of any discount should be limited to the petitioner's share of the estimated cost of a partition of the property." Fortunately for taxpayers, the Tax Court has routinely acknowledged that partition cost is but one factor and has frequently allowed much greater discounts. In a subsequent TAM 199943009, the Service appeared less rigid by stating that allocating partition cost is "[o]ne method for determining the fair market value of an undivided interest in property..." However, the IRS's method of considering the cost of partition for measuring discounts was rather simplistic. It proposed that the cost of partitioning the property could be merely estimated, followed by a deduction of the interest's allocable share of the cost.

The Tax Court laid down the law (literally) about how to perform a partition analysis in *Barge*[2]. After struggling with the testimony of each side's experts, the Court performed its own analysis. Based upon the evidence in front of it, the Court estimated that a partition sale of the subject timberland would take four years. Next, the court prepared a four year cash flow projection that included legal costs, interim income from the property, and the property's appreciation during the period. The court discounted the net projected cash flow to present value and compared the result to the fair market value of the subject at the valuation date. According to the court, a discount of 26% was reasonable.

The Tax Court's discounted cash flow method in *Barge* became the standard for partition analysis, even for the IRS. In *Brocato*,[3] the Service argued for such an approach from the outset. Unfortunately, it succumbed to the temptation of relying on unreasonable assumptions. It was not able to persuade the court that a partition in San Francisco could be completed in six months for a cost of $20,000. The court relied instead on the testimony of taxpayer's expert (Paul E. Talmage) who presented a compelling group of direct market comparables.

The evolutionary trail blazed by the cases has to do with the relevancy of supporting evidence. The Tax Court now demands that the surveys, studies and other data cited by experts be related to the market for undivided interests in real estate, and not some other market, such as, that of restricted stocks. At one time, market data supporting minority interest and marketability discounts for non-public stocks may have been accepted as sufficient evidence when arguing the magnitude of discounts for undivided interests. This is no longer true. While stock transaction data may be considered informative, the Tax Court now expects the discounts to be based on surveys of transactions in undivided interests if not direct market comparables.

To appreciate how the bar is being raised, one should read *Busch*[4] and *Stevens*[5]. Both of these cases involve the same judge and same expert for the taxpayer, but with progressively better results for the taxpayer. Next, one can take a look at *Baird*,[6] and see the weight the court gave to the opinion of the taxpayer's expert because of his 20 years of first-hand experience buying and selling undivided interests.

Market Data

In response to the increasing demand for relevant market data, certain members of the valuation community have conducted surveys of transactions in undivided interests. It is not an easy task. There are no local multiple listings or data bases of "comps" for undivided interests. The surveyor must instead solicit data from the population of likely intermediaries (frequently attorneys). The responses are meager and the details frequently vague. After rejecting incomplete, anonymous, unverifiable, or otherwise suspect responses, the results can be somewhat disappointing.

Moreover, although these surveys are very useful to the professionals conducting them, they are of more

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EXHIBIT 2
Analysis of Contested Partition And Related Discount From Full Value

Net Cash Inflow Year 1 (See Exhibit I)		$4,000
Year 2:		
Cash Inflows:		
Projected annual rental income (per appraiser)		28,000
Cash Outflows:		
Projected annual operating expenses (per appraiser)		6,500
Legal fees related to partition proceedings		10,000
Total Cash Outflows		16,500
Net Cash Inflow Year 2		11,500
Year 3:		
Cash Inflows:		
Projected annual rental income (per appraiser)		28,000
Value per appraisal	400,000	
Appreciation during proceedings (3% over three years)		37,091
	437,091	
Discount related to judicial sale (10%)	(43,709)	
		393,382
Referee's fees (6%)		(23,603)
Total Cash Inflows		397,779
Cash Outflows:		
Projected annual operating expenses (per appraiser)	6,500	
Legal fees related to partition proceedings	10,000	
Environmental remediation	25,000	
Total Cash Outflows		41,500
Net Cash Inflow Year 3		356,279
Present Value of Year 1 Net Cash Inflow (discounted @11%)		3,604
Present Value of Year 2 Net Cash Inflow " "		9,334
Present Value of Year 3 Net Cash Inflow " "		260,508
Present Value of Proceeds from Partition		273,445
Full Value of Proceeds		400,000
Amount of Discount arising from partition		126,555
Percentage Discount arising from partition		31.6%

limited use to everyone else. This is because, even though some of the survey statistics are published and may be cited, there is no access to the underlying data because it is proprietary. Some of the most frequently cited surveys are summarized below:

FMV Undivided Interest Discount Study. A study conducted by FMV Opinions reached the following conclusions:

- Covered 40 transactions from 1971 to 1993.
- Overall average discount of 34%.
- Average discount of 27% for properties producing significant income.
- Discounts for undivided interests above 50% were slightly lower than undivided interests less than 50%.
- Discounts higher during times of recession.

The Healy Survey. A study conducted by a real estate appraiser in Beaverton, Oregon reached the following conclusions:

- Covered nearly 100 sales of partial real estate interests.
- After elimination of non-arm's-length transactions, the average discount was 23.5%.

The Willamette Management Associates Studies. A study conducted by Willamette Management Associates (one of a number of studies conducted by Willamette) reached the following conclusions:

- Covered nine confirmed transactions in undivided interests in real property in 1985.
- Majority of transactions were 50% interests.
- Average discount was 15%, median was 16%.

Eckhoff Accountancy Data. A study compiled by Eckhoff Accountancy Corporation reached the following conclusions:

- Contained 61 transactions.
- Covered seven states.
- Included undeveloped land, agricultural land, commercial property, and residential rentals.
- Average discount was 37%.
- Median discount was 38%.

The Eckhoff Accountancy Corporation (the author's company) compiled its own searchable database of transactions. It did not conduct a survey. Rather, it built the database piecemeal by gathering high quality transactional data from contacts, and then used the accumulated data to barter for more. Many of the company's contacts (mostly colleagues in the valuation community) were in the same boat, and transactional data became a currency of exchange. Not surprisingly, duplicate and other unacceptable forms of information popped up. At the end of the day, the company had scrubbed, sifted and pared its database from more than 120 records down to 61 unduplicated and very reliable relevant transactions.

How To, Dos and Don'ts

Now, as promised, the article will offer recommendations on how best to determine and support the appropriate discounts for undivided interests in real estate. Eckhoff Accountancy Corporation is a firm of Certified Public Accountants with expertise in business valuation, and not real estate appraisal. Accordingly, Eckhoff is part of a team, in which a qualified appraiser provides the estate with the value of property as a whole, and Eckhoff provides an opinion on the appropriate discount.

1 Hall, "Should the IRS Surrender Cost-to-Partition Discounts for Undivided Interests?," 1 Val. Strat. 24 (January/February 1998); Webb and Lunn, "Would You Buy an Undivided Interest?," 2 Val. Strat. 24 (September/October 1998); Humphrey, "Tenancy In Common A Real Estate Appraiser's Viewpoint," 4 Val. Strat. 30 (January/February 2001); Hoffman, "Based on This Unsatisfactory Evidence--An Interpretation of the Tax Court's Decisions Regarding Undivided Interest Dividends," 4 Val. Strat. 18 (May/June 2001); Humphrey, "Peace Treaties For Tenants In Common," 4 Val. Strat. 34 (July/August 2001).

2 TCM 1997-188.

3 TCM 1999-424.

4 TCM 2000-3.

5 TCM 2000-53.

6 TCM 2001-258.

Do not:

1. Base your conclusion on takeover studies, restricted stock studies, IPO studies, partnership transaction data, or REIT studies. They maybe cited as analogous data, but they are all different, and ultimately all attempts to reconcile them to undivided interests are extremely subjective.
2. Rely on statistical highlights of other firms' surveys of undivided interest transactions. The Tax Court wants greater amounts of direct comparable data. There is no way of knowing whether the transactions in these surveys are representative of the subject interest.
3. Ignore the possibility of partition. It is a given that the IRS is going to present a partition analysis in its argument. It is possible, if not likely, that the assumptions in its analysis will be biased in its favor. The analyst should include his or her own well reasoned and supportable partition analysis.

Do:

1. Invest the resources to compile a searchable transaction database, either by survey or information sharing. It is time-consuming, but worth it. The author's experience is that the efforts pay for themselves in a very short period.
2. Refer to the takeover studies, restricted stock studies, IPO studies, partnership transaction data, and REIT studies as analogous data. However, do not base a conclusion solely on them.
3. Refer to the statistical highlights of other firms' surveys of undivided interest transactions. They help to support your own statistics. Again, do not base a conclusion solely on them.
4. Make sure you obtain an appraisal of the subject property's value as a whole from a qualified, reputable real estate appraiser and read his or her report thoroughly. An opinion regarding the appropriate discount must be based on the facts and circumstances involved. The real estate appraiser's report is a good source for this information.
5. Interview the operators of the property and as many interest holders as practical. Again, a conclusion should be facts and circumstances driven, so become knowledgeable of as many facts and circumstances as possible.
6. Research the partition options. First, determine if the property can be partitioned in-kind (a legal opinion may be needed). If it is, consider both partition in-kind and partition sale. Next, become familiar with the legal environment for partition actions in the subject property's locale. Each state has its own laws governing partition. Availability of court dates, legal costs, role of referees etc., vary by county. Research the code in the state where the subject is located. Interview attorneys in the subject's area about the duration and costs of partition actions.
7. Perform a *Barge* style partition analysis. If appropriate, present the analysis on both an uncontested and contested basis. The two will differ in projected duration and cost.
   - Use the duration and cost information obtained from point 6 above to project legal fees and transactional costs likely to occur during the partition period.
   - Project the partition period operating revenue and expenses based on those disclosed in the real estate appraiser's report.
   - Obtain objective information regarding the likely partition period appreciation of the property (if any). This information may be contained in the real estate appraiser's report.
   - To discount the partition period cash flow to present value, use a rate derived from the real estate appraiser's capitalization rate. Remember that the appraiser's rate is for capitalizing current net cash flow. It will probably have to be adjusted slightly to obtain a rate appropriate to discount future cash flow. Such adjustment factors (e.g., projected inflation) are probably

disclosed in the appraiser's report.

- See accompanying Exhibits 1 and 2 and related assumptions for illustration of both contested and uncontested partitions.

8. Pull together all results and reach a conclusion. Carefully consider all evidence and analysis. What are their relative strengths and weaknesses? How do they reconcile with each other? After considering the foregoing and all other relevant facts and circumstances, base a conclusion on market analysis, partition analysis, or some weighting thereof.

Partition Analysis Illustration

The following partition assumptions were based on discussions with attorneys experienced in partition actions in the subject subject property's county, and details included in the real estate appraiser's report:

- It will take 90 to 120 days and a minimum of $5,000 to get the first hearing and interlocutory judgment.
- It will take a minimum of two years and $5,000 to $10,000 per year per party to complete the sale and divide the proceeds.
- The court generally appoints a referee (who may also be a broker) who is paid either hourly or by commission (generally 6%).
- There is usually a 10% to 20% discount from the otherwise fair market value of the property.
- There is property appreciation of 3% annually during the partition period, based on the real estate appraiser's report on the fee simple interest.
- There are necessary appraisal costs and survey fees of $1,500 and $1,000 respectively applicable to the first year.
- Operation of the property will continue through the partition period. Rental revenue and operating expenses are based on those used by the real estate appraiser in an income approach.
- An environmental remediation costing $25,000 is required before sale.
- A discount rate is estimated as follows:

Capitalization rate utilized by real estate appraiser	7.0%
Expected long-term growth rate	3.0
Incremental risk and uncertainty	1.0
Discount rate	11.0%

The projected cash flow, present value, and discount arising from partition for an uncontested sale are presented at Exhibit 1. The projected cash flow, present value, and discount arising from partition for a contested sale are presented at Exhibit 2. The two exhibits are fundamentally the same, except that the uncontested partition is projected to take two years and the contested proceeding is projected to take three.

As can be seen from these exhibits, the discounts associated with the partition process are 29.0% for an uncontested partition and 31.6% for a contested partition. In reaching a conclusion, these results would be considered in relation to the analysis of comparable transactions. Selection of one method over the other, or whether to combine the two methods, should be based on the facts and circumstances relevant to the case.

Conclusion

The foregoing is the author's current strategy for determining the discounts on undivided interests in real estate. These methods should continue to be adjusted as the evolution of this process continues in the marketplace and the court system. It is hoped that this article will be of some assistance in applying the guidance included in previously published articles and provided by the Tax Court cases. •