Valuing Real Estate Fractional Ownership Interests

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Intangible asset valuation analysts are often called on to perform fair market value valuations of real estate undivided ownership interests (also called fractional ownership interests). Many of these real estate undivided interests are owned by holding companies or by high net worth individuals. Accordingly, those real estate fractional ownership interests may need to be valued for federal gift or estate tax compliance purposes or for intergenerational wealth transfer and estate planning purposes. This discussion provides an explanation of the defining characteristics of real estate fractional ownership interests. And, this discussion introduces (1) the valuation approaches and methods, (2) the relevant judicial precedent, and (3) the investment risk and expected return factors that the intangible asset valuation analyst should consider when valuing these types of fractional ownership interests.

What Is a Fractional Ownership Interest?

A real estate fractional ownership interest, also called a tenancy in common interest, exists when two or more co-tenants each own a separate fractional share of undivided real property. For purposes of this discussion, the terms fractional ownership interest and undivided ownership interest are used synonymously.

Unlike a joint tenancy ownership, there is no right of survivorship among tenants in common. A tenancy in common requires only the unity of possession of the subject real estate.

In the absence of an agreement between the co-tenants, each co-tenant may possess and enjoy the entire real estate. For example, each co-tenant has the right to use and to enjoy a share of the property's income.

Although each co-tenant has an equal right to possess and enjoy the real estate, he or she cannot:

1. exclude the other co-tenants or
2. designate any portion of the real estate as his or her own.

In the case of a single-family home, or any other type of residential property that can not be subdivided, each co-tenant's right to use and enjoy the real estate can create potential problems.

Fractional ownership interests often result when partners (i.e., business or family partners) acquire the real estate without (1) the use of a holding company entity structure or (2) the transfer of the property between family members.

By their very nature, real estate fractional ownership interests typically suffer from the following valuation influences:

1. a lack of marketability
2. a lack of ownership control

Property-Specific Factors to Consider in the Valuation Analysis

1. Co-Tenant Rights, Privileges, and Obligations under State Law.
   - Partition—A co-tenant typically may compel a partition of the subject real estate. When the subject real estate is

partitioned, then each co-tenant takes a distinct part—according to his or her respective ownership interest.

The purpose of a partition is to allow the tenants in common to sever their ownership interests. The partition enables each tenant to take possession, enjoy, and improve his/her separate real estate parcel at his or her own pleasure. If, because of its physical nature, the subject real estate cannot be equitably divided in-kind, then:

a. the entire property may be ordered by a court to be sold and
b. the entire property sale proceeds may be ordered to be divided among the co-tenants.

- Conveyance and Sale—Tenants in common each hold separate ownership interests. These separate ownership interests can be sold, conveyed, or transferred without the consent of the other fractional interest owners.

  One tenant in common cannot bind his/her nonconsenting co-tenants in any disposition of their undivided interest in the common real estate.

- Contribution and Costs—Each co-tenant also has a right to a contribution from his/her co-tenants. For example, each co-tenant is responsible for the costs associated with his or her co-tenancy interest, including real estate taxes and property insurance.

2. Written Agreement of Co-Tenancy.

   The greater the number of co-tenants owning a piece of the property, the greater the potential for conflict in deciding how the property should be managed.

   Many potential conflicts between the co-tenants could be avoided if the co-tenants executed an agreement that describes how the real estate will be used or managed.

3. Debt Obligations.

   A hypothetical buyer of a real estate undivided ownership interest typically would consider whether the subject property was encumbered by a mortgage loan. In addition, the hypothetical buyer typically would be concerned with:

   - whether the co-tenants are jointly and severally liable for the debt obligation,
   - whether the debt obligation is assumable by the buyer of an undivided ownership interest,
   - whether the partition of the property or a sale of an undivided ownership interest in the property results in the call of the debt obligation, and
   - whether the holder of an undivided ownership interest is at risk of losing his or her interest if the lender forecloses on the subject property.

4. Ability to Subdivide the Real Estate.

   A hypothetical buyer of a real estate undivided interest would generally prefer an interest in a parcel of land that is capable of being subdivided rather than in a parcel of land that is not capable of being subdivided.

5. Historical Sales of Undivided Interests.

   Although uncommon, any history of arm's-length sales of undivided interests of the subject property may be relevant to the valuation analysis.

6. Restrictions on Transferability of an Interest.

   Any restrictions on the transferability of the subject property may be relevant to the valuation analysis.

7. Lack of Income to Cover Expenses.

   The valuation analyst should consider the income-producing capacity of the subject real estate. The valuation analyst should also consider whether there is sufficient property income in order to cover the real estate property tax and other operating expenses.

Generally Accepted Valuation Approaches and Methods

There are two valuation approaches and methods that valuation analysts commonly use to value a real estate fractional ownership interest:

1. the market approach and the sale transaction analysis valuation method
2. the income approach and the partition analysis valuation method

Market Approach—The Sale Transaction Analysis Method

This market approach valuation method is based on a comparison of the subject fractional interest to published studies of empirical data regarding arm's-length sales of fractional interests.

First, the valuation analyst obtains a valuation of the fee simple interest in the subject real estate from an independent real estate appraiser. Second, the valuation analyst reviews:

1. the subject property's physical and economic characteristics and
2. the relevant real estate market.

These property-related and market-related factors are typically described in the real estate appraisal report and in other publicly available sources.

Third, this stage of the fractional interest valuation analysis is typically presented as a simple adjusted net asset value (ANAV) indication. That is, the subject real estate fee simple value indication is adjusted for:

1. any outstanding mortgages or
2. other encumbrances.

The conclusion of the fee simple interest value minus outstanding mortgage/other encumbrance amount is the real estate ANAV.

Fourth, the valuation analyst will compare:

1. this subject real estate ANAV value indication to
2. published studies of empirical data on real estate undivided interest actual sale transactions.

In this procedure, the valuation analyst "fits" the subject property into the published empirical sale data. This comparison of subject real estate to sale transaction data allows the analyst to select a property-specific undivided interest valuation price discount.

This property-specific but market-derived valuation price discount typically reflects the combined price adjustments related to: (1) a discount for lack of control (DLOC) and (2) a discount for lack of marketability (DLOM).

Exhibit 1
Fair Market Value of the Subject Fractional Ownership Interest
Market Approach
Sale Transaction Analysis Valuation Method
Simplified Illustrative Example
As of December 31, 2009

Name of the Subject Property

1544 County Highway
The Villas at Santa Rosa Beach

Description of the Subject Property

Type:	Residential Condominium	
Location:	Santa Rosa Beach, FL	
Year Built:	1998	
Property Tax Assessment Value:	$949,850	for the 2009 Tax Year
Most Recent Sale of the Subject Property	None	as of December 8, 2009

Undivided Interest Fair Market Value Estimation	Value Indication
Indicated Fee Simple Interest Market Value of the Subject Property [a]	$ 850,000
Times: Subject Undivided Interest Ownership Percentage	45.0980%
Equals: Indicated Pro Rata Value of the Subject Undivided Ownership Interest (Before any Valuation Price Adjustment)	383,333
Selected Valuation Price Adjustment for the Subject Undivided Ownership Interest at 22% [b]	(84,333)
Indicated Fair Market Value of the Subject Undivided Interest	**$ 299,000**
Indicated Fair Market Value of the Subject Undivided Interest (rounded)	**$ 300,000**

Notes:
[a] Based on a market value fee simple interest real estate appraisal of the subject property by the Accurate Appraisal Company as of December 31, 2009.
[b] Based on the valuation analyst's comparative assessment of the published empirical evidence of real estate fractional interest sale transactions that indicate typical price discounts within a range of between 15% and 35%. Several of these published studies of empirical sale transaction data are summarized in the Sale Price Discount Empirical Data section of this discussion.

Exhibit 1 illustrates a simplified example of this market approach sale transaction analysis valuation method. This valuation method—and this simplified illustrative example—are based on the analysis of published empirical real estate fractional interest sale transaction data.

Exhibit 2
Fair Market Value of Subject Fractional Ownership Interest
Income Approach
Partition Analysis Valuation Method
Simplified Illustrative Example
As of December 31, 2009

Expected Time Period for a Successful Legal Partition and Sale of the Partitioned Property [a]	1.5 years
Indicated Real Estate Fee Simple Interest Market Value of the Subject Property [b]	$ 850,000
Multiplied by: Expected Property Price Appreciation at 4% per Year for 1.5 Years [c]	1.061
Equals: Expected Future Sale Price of the Subject Property Rate, Assumes the Expected Partitioned Property Sale Date	$ 901,700
Multiplied by: Subject Undivided Ownership Interest Percentage	45.0980%
Equals: Pro Rata Allocation of the Expected Future Sale Price of Real Estate Fee Simple Interest	$ 406,600
Less: Pro-Rata Portion of Real Estate Partition Costs, Assumes 10% Expected Fee Simple Interest Sale Price [d]	40,700
Projected Value of Undivided Interest at Expected Partitioned Property Sale Date, net of Partition Costs	365,900
Present Value Discount Factor at 15% Discount Rate for Partition/Holding 1.5 Years [e]	.8089
Present Value of Net Sale Price (after Real Estate Partition Costs) of Partitioned Real Estate	$ 296,000
Indicated Fair Market Value of the Subject Undivided Interest (rounded)	**$ 300,000**

Notes:
[a] Based on the estimated amount of time to pursue a state court partition legal action. Includes the expected marketing time to sell the partitioned real estate once the partition legal action is completed.
[b] Based on the market value fee simple interest real estate appraisal performed by the Accurate Appraisal Company as of
[c] Based on a 4 percent expected compound annual rate of price appreciation in the value of the subject fee simple interest real estate during the expected partition legal action and market exposure period of 18 months.
[d] Estimated legal, engineering, site modification, and administrative expenses associated with (1) the state court partition action and (2) the physical partitioning of the real estate.
[e] Based on the opportunity cost (or required rate of return) of similar risk class assets and on the risk of a successful real estate partition litigation and partitioned property sale.

Income Approach—The Partition Analysis Method

The second generally accepted valuation method for a real estate undivided ownership interest is an income approach valuation method.

In this valuation method, the valuation analyst will quantify the expected costs (i.e., out-of-pocket expenses and investor opportunity cost) to partition the subject real estate.

This real estate partition cost analysis typically includes two cost components. The first cost component is the cost to bring a real estate partition lawsuit. The second cost component includes the costs associated with the delays and the uncertainty related to the real estate partition action.

Some of the direct costs, indirect costs, and opportunity costs that are typically considered in the real estate partition cost analysis include the following:

- the expense of the real estate partition lawsuit
- the probability of the real estate partition lawsuit success
- the amount of time required to complete the partition lawsuit
- the cost to survey the subject real estate
- the engineering and the structural cost to physically divide the subject real estate (if necessary)
- the cost to replace any shared property access, utilities, etc. infrastructure
- the uncertainty related to selling the resulting partitioned real estate
- the time required to complete the post-partition real estate sale.

Of course, a fair market value analysis of a real estate undivided interest should not consider real estate sale commissions or other property selling expenses. This is because fair market value represents the price that a property buyer would pay to a property seller—and not the after-selling expense net sale proceeds in the pocket of the property seller.

This income approach valuation method incorporates the future economic benefits of the fractional ownership based on the investment risk and the expected investment return of the subject undivided interest.

Any value decrement between (1) the pro rata real estate fee simple interest market value and (2) the economic benefit of the pro rata real estate sale proceeds (net of partition and holding expenses other than real estate selling expenses) represents (3) the price "discount" required to induce a buyer to purchase and a seller to sell the undivided interest.

Exhibit 2 presents a simple illustrative example of this income approach partition analysis valuation method.

Fractional Interest Basis for the Valuation Price Adjustment

The principal considerations in the valuation of a real estate fractional ownership interest relate to the type and the scope of the legal rights that the fractional interest owner can convey.

The real estate fractional interest derives its value from the relationships among the co-owners, and not from a direct percentage of the real estate fee simple interests market value.

Under the property laws of most jurisdictions, all co-owners enjoy equal rights to the subject real estate. This statement is true unless there is some contractual instrument (e.g., that created the co-ownership) between the parties that specifies otherwise.

These state property statutes give rise to the following valuation considerations. These valuation considerations could influence the amount of the price adjustment (i.e., valuation discount) to the real estate fractional interest, relative to the pro rata real estate fee simple interest market value to a single property owner:

- All co-owners enjoy equal access to the subject real estate, but not exclusive access to any particular part of the subject real estate.
- All co-owners have to approve any actions taken with regard to the subject real estate. A co-owner expending an amount to preserve or maintain the property may then approach the other co-owners for reimbursement, to the extent he or she is entitled.
- The sale of the subject real estate in its entirety requires the active cooperation of all of the co-owners.
- If the real estate is to be partitioned into smaller units to allow each co-owner to have his or her own fee simple parcel, then the active cooperation of all the property co-owners is required.

Valuation Aspects of the Fractional Interest DLOC and the DLOM

Each of the above-listed valuation considerations indicates that an undivided real estate fractional interest lacks many of the elements of ownership control and of marketability that a real estate fee owner has.

Some of these fee simple ownership control and marketability elements include:

- Lack of typical mortgage financing.

  Typically, the other property co-owners may be unwilling (1) to obligate themselves to repay borrowings that went to the subject fractional interest owner or (2) to expose their ownership interest in the subject real estate to foreclosure.
- Lack of the typical sale channels.

  Because of the lack of typical mortgage financing, a fractional interest transfer is more likely to be a sale for cash only. Also, unless the property co-owners agree, real estate brokers and multiple listing services will not handle undivided interest offerings without the signature of all of the co-owners (i.e., something that an individual co-owner cannot control).
- Lack of typical real estate buyers—i.e., a relatively illiquid market.

  The majority of real estate sales in the United States are fee simple, single ownership interests. And, the vast majority of real estate buyers appear to prefer fee simple ownership.

  A Willamette Management Associates analysis of real estate transfers within a sample geographic area (discussed below), indicated that real estate fractional interests comprised only a fraction of one percent of the total real estate transactions for the analysis period.
- The single fee simple owner will never have to incur the cost to defend his or her

fractional interest against the actions of other co-owners.

- If a co-owner wishes to dispose of his/her fractional interest, then the co-owner has three alternatives:
  1 to complete the sale of the fractional ownership interest,
  2. to seek a voluntary property partition, or
  3 to request the appropriate court to involuntarily partition the subject real estate.

  The latter two fractional interest disposition alternatives involve time, expense, and uncertainty that a single fee simple interest owner will not experience.
- The other co-owners typically are under no binding obligation to purchase the fractional interest. Nor are the other co-owners obligated to pay any particular price for the subject fractional interest if they, in fact, do decide to buy that real estate undivided interest.

For these fundamental supply and demand reasons, basic economics principles indicate that a real estate undivided interest should sell at a price discount compared to the pro rata fee simple market value of the subject real estate.

Sale Price Discount Empirical Data

A number of empirical studies have quantified the actual price discounts associated with real estate undivided interest actual sale transactions.

What do these empirical studies conclude? The published studies generally indicate that fractional interests in properties that generate significant income tend to sell for a below average price discount. The published studies also generally indicate that larger fractional interests (i.e., a greater than a 50 percent ownership interest) tend to sell for a below average price discount.

Several of these published studies of real estate fractional interest empirical sale data are summarized below.

Harris-McCormick-Davis Study

In an article that appeared in the American Society of Appraisers publication *Valuation*, in December 1983, the authors described a survey of undivided fractional interest sale transactions.[1]

The real estate fractional interest sale transactions were between unrelated buyers primarily located in the Southeast. The 21 sale transactions in the survey indicated an average price discount of 32.05 percent, with a standard deviation price discount of 8.29 percent.

The sale transaction price adjustments ranges from a price premium of 5.56 percent to a price discount of 86.95 percent.

Both of these two extreme fractional interest sale transactions were considered to be "unusual circumstances" and were discarded from the analysis by the authors.

Healy Study

Martin J. Healy Jr. prepared a study of undivided fractional interest sale transactions that was published in *The Appraisal Journal* in July 1988.[2]

The Healy study involved "nearly 100" fractional interest sale transactions, all "primarily in the vicinity of Portland, Oregon."

Healy found numerous non-arm's-length motives for a number of the undivided interest sale transactions. Therefore, Healy rejected some of the sale data as not being characteristic of arm's-length market sale transactions.

Of the real estate fractional interest sale transactions that were retained in the relevant sample, the average price discount was 23.5 percent; and, the range of price discounts was between 3 percent and 52 percent.

Peter Patchin Study

Peter J. Patchin, CRE, MAI, authored a study of real estate undivided fractional interest sales that was published in *Real Estate Issues*, Fall/Winter 1988 edition.[3]

Patchin collected fractional interest sale transactions from real estate appraisers' records for properties located in Minnesota, Texas, California, and other states in the Southwest.

The total number of fractional interest sale transactions in the Patchin study was 54, with some 29 of these sale transactions being apartment limited partnership interests. The average price discount associated with this study of fractional interest sales was 36.8 percent. The range of price discounts of fractional interest sales was between zero percent and 82.4 percent.

Peterson-Hansen-Klafter Study

In a private study for a client, real estate appraiser William D. Peterson, MAI, SRPA, of Tucson, Arizona, prepared an analysis of arm's-length sale transactions in undivided interests in real estate.

The fractional interest sale transactions occurred in the Tucson area from 1980 through 1986. Peterson also included data from a study provided by John T. Hansen, MAI, and Mark H. Klafter, MAI, based on sale transactions in the same area through 1983.

The number of real estate fractional interest sale transactions included in the Peterson study totaled 13, and the average price discount indicated by these transactional data was approximately 50 percent. The range of the sale price discounts was from 23.4 percent to 83.45 percent.

It should be noted that the Tucson, Arizona, real estate market was experiencing an unstable real estate investment climate during the analysis time period.

FMV Opinions Study

The FMV Opinions study included real estate undivided interest sale transactions that occurred over a 20-year period. The FMV Opinions study included 30 such undivided interest sale transactions.

The study concluded a mean price discount of 34.8 percent and a median price discount of 32.5 percent.[4]

Humphrey Study

Walter and Bruce Humphrey, two real estate appraisers in Northwest Florida, conducted a study of some 24 real estate fractional interest sale transactions.[5] Based on these undivided interest sale transactions, the overall price discounts ranged from zero percent to 67 percent.

The Humphreys did not develop a central tendency price discount from the study data. However, the Humphreys suggested a formula for quantifying a fractional interest price discount. And, the Humphreys suggested that 50 percent was the threshold price discount for undivided interests.

In the Humphrey study, undivided fractional interests included a significant number of undeveloped land sales and farm land transactions.

Eckhoff Accountancy Corporation Study

This accounting firm study, led by firm partner Ted Israel, analyzed 61 real estate fractional interest sale transactions for its database of undivided interests.[6]

The fractional interest properties were located in seven states and included:

1. undeveloped land,
2. agricultural properties, and
3. commercial and multifamily residential rental properties.

In the Eckhoff Accountancy Corporation study, the average price discount was 37 percent, and the median price discount was 38 percent.

Willamette Management Associates Studies

Willamette Management Associates (WMA) prepared a number of fractional interest price discount studies in various parts of the country. These studies were conducted both independently and in conjunction with local real estate appraisers.

In one study, WMA reviewed all real estate transfer tax records for two counties in the state of Washington for a one-year period during 1985–86. Of a total of approximately 23,000 real estate transactions, only 50 (0.22 percent, or one in every 460 transactions) were undivided interest sale transactions.

WMA analysts then interviewed the parties to each of these sale transactions in order to determine the arm's-length nature of the sale transactions.

Of the 50 real estate fractional interest sales, only nine sale transactions were at arm's length. The average price discount associated with this group of sale transactions was approximately 15 percent, with a range of a 16 percent price premium to a 55 percent price discount.

The WMA comparison was based on using the total real estate property tax assessment value, which typically lags the actual sale price of properties by approximately 10 percent, due to the typical one-year or longer lag in property tax assessment updates in this area.

Therefore, the total indicated price discount adjustment implied in the WMA study is on the order of 25 percent. This price discount conclusion is consistent with other WMA studies that concluded average price discounts equal to and greater than 25 percent.

In summary, the empirical evidence from all of these empirical studies supports the principle of a price discount adjustment to the pro rata fee simple market value of the real estate undivided interests.

The central tendency of the price discounts concluded in these various studies falls within a range of between 15 and 35 percent.

Selected Judicial Precedent Involving Fractional Interest Price Adjustments

The courts have considered a variety of quantitative and qualitative considerations in the judicial determination of the value of real estate undivided ownership interests.

Some of these judicial considerations include the following:

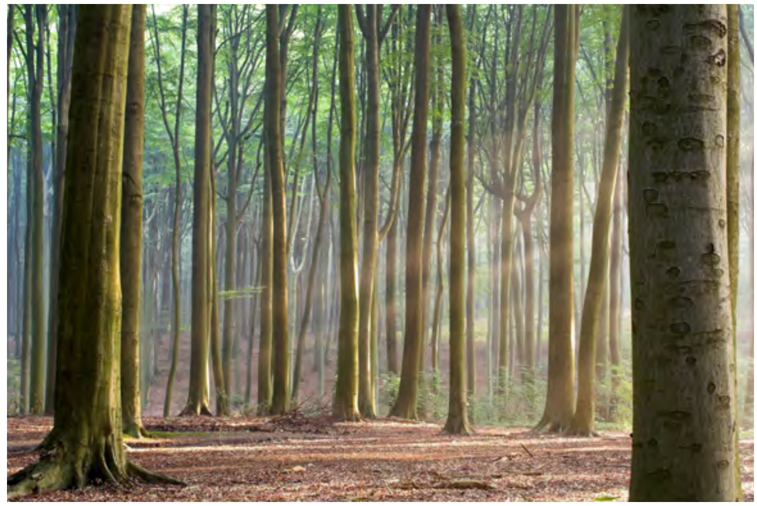
- the appropriateness of the fee simple interest real estate appraisals, the selected real estate valuation approaches and methods, the selected capitalization rates, and so forth
- the sales of comparable real estate undivided fractional interests
- the number of co-owners of the subject real estate
- the amount of time required to realize income from the subject real estate or to achieve a rate of return on the subject property investment
- the time and the cost to partition the subject real estate
- the lack of management of the subject real estate
- the lack of liquidity of the subject real estate fractional interest

No single real estate fractional interest valuation method is universally accepted by the courts. In addition, the level of the valuation price adjustments allowed by the courts has varied on a case-by-case basis.

Some courts have cited the relative lack of control and lack of marketability of a real estate undivided interest when compared with a real estate fee simple ownership. Other courts have focused solely on the out-of-pocket expenses associated with a partition legal action.

The following discussion summarizes several court cases that involve the valuation of a real estate fractional interest.

1. *Estate of Forbes v. Commissioner*.[7] The real estate undivided interests at issue



included (1) a 42 percent undivided interest in 3,321 acres and (2) a 42.9 percent undivided interest in 2,033 acres. The taxpayer applied a 30 percent fractional interest price discount.

   The Internal Revenue Service (the "Service") applied an 18 percent fractional interest price discount. The court accepted the taxpayer expert's recommendation for a 30 percent price discount.

2. *Estate of Williams v. Commissioner*.[8] The decedent owned a 50 percent undivided interest in Florida timberland. The court accepted the taxpayer's 44 percent total price discount from the appraised fee simple interest market value.

   The 44 percent price discount was based on a lack of control discount of 30 percent and a lack of marketability discount of 20 percent, with the two valuation discounts applied in succession.

   This judicial decision ignored the position often taken by the Service that any discount from the appraised fee simple interest market value should be limited to the estimated cost of a partition legal action.

   The court considered the potential $413,000 in property partition costs and real estate commissions of 10 percent that would be incurred upon the partition and/or sale of the property in its determination of the discount for lack of control.

   The court viewed the lack of comparable undivided interest sale transactions as in indication of the lack of marketability of the subject interest.

   The Service expert testified that a business appraiser was not qualified to value the subject undivided fractional interests. The court disagreed with the Service expert, stating that the taxpayer expert "was an experienced business appraiser who has given expert opinions in valuing fractional interests in partnerships, businesses and real property."

3. *Estate of Barge v. Commissioner*.[9] The taxpayer requested that the court apply a price discount of 50 percent to the appraised fee simple value of the property in order to calculate the real estate undivided interest value. In its decision, the court used a cost to partition analysis to calculate the undivided interest value.

   The court-determined value resulted in an effective undivided interest price discount of 26 percent from the appraised fee simple interest market value.

4. *Shepard v. Commissioner*.[10] The taxpayer presented three real estate appraisers to support the taxpayer's valuation of the leased timberland. Two of the appraisers applied price discounts for undivided interests of 27 percent and 15 percent, respectively.

   The Service presented one appraiser who appraised the value of the land in fee simple interest with no price discount for lack of control or for lack of marketability.

   The court ultimately concluded that the appropriate price discount for the undivided interest was 15 percent.

   The Service expert concluded that the price discount should be limited to the estimated cost to partition. The court rejected the opinion of the Service expert as "failing to give adequate weight to other reasons for discounting a fractional interest in the leased land, such as lack of control in managing and disposing of the property."

5. *Estate of Della Walker van Loben Sels v. Commissioner*,[11] allowed a 60 percent fractional interest price discount for an undivided (tenancy in common) interest in 11 tracts of timberland. The undivided interests ranged in ownership interest from 2.48134975 percent to 25.82349 percent.

6. *Estate of George W. Youle v. Commissioner*,[12] allowed a 12.59 percent fractional interest discount for a 50 percent undivided tenancy in common interest in 254 acres of farmland where no comparable sale transactions were introduced by the estate's expert.

7. *Estate of Wildman v. Commissioner*.[13] This decision allowed a total 40 percent valuation adjustment for the decedent's 20 percent undivided tenant in common interest in 1,212.4 acres of farmland.

   The 40 percent price discount consisted of (1) a 15 percent discount for minority interest, plus (2) an additional 10 percent discount to reflect (a) the lack of ownership of the irrigation facilities and (b) the fact that the interest is not comprised of contiguous portions of land, plus (3) an additional 15 percent lack of marketability discount.

   The additional 15 percent discount was taken because (1) the restrictions in the agreement on the decedent's sale or transfer of her interest created an impediment that a hypothetical buyer would consider and would require some adjustment to the seller's offering price, and (2) the terms of the agreement could generate controversy and litigation, i.e., a partition action.

8. *Samuel J. LeFrak v. Commissioner*.[14] Samuel L. LeFrak ("LeFrak") and his wife resided in Woodmere, New York. Mr. LeFrak was a builder, developer, and manager of rental real estate in New York City, and held interests in over 200 parcels of real property during 1976. The buildings were held in corporate, partnership, and sole proprietorship form, and were operated through the LeFrak Organization, which Mr. LeFrak directed and controlled.

   Toward the end of 1976, because LeFrak was aging and because real estate values in New York City were low due to poor economic conditions, petitioner decided to make gifts to his children.

   On December 30, 1976, for the purpose of making gifts, LeFrak conveyed interests in 22 buildings, consisting of 20 apartment buildings and two office buildings located in the boroughs of Queens and Brooklyn (hereinafter sometimes referred to as "the buildings"), to his children individually or to trusts created for their benefit. The apartment buildings were subject to the New York City rent stabilization laws, while the office buildings were not.

   Prior to the conveyances, 20 of the buildings were held by petitioner individually and operated as sole proprietorships, and 2 were held by partnerships in which petitioner held a 96 percent interest and his children (or trusts for their benefit) held the remaining 4 percent.

   On December 30, 1976, LeFrak formed 20 partnerships with his children or their trustees. Each of the partnerships was to own and operate one of the 20 buildings which were formerly held by him individually as sole proprietorships.

Each of the buildings was conveyed to LeFrak and the donees as tenants in common, doing business as the particular partnership formed to hold the respective building conveyed. The deeds were recorded on December 30, 1976.

A Business Certificate for Partners for each partnership was filed with the County Clerk of Queens County on December 30, 1976. LeFrak conveyed to each donee a 7.5-percent interest in each of the buildings, subject to the outstanding mortgages. The conveyances of the buildings were made to Richard LeFrak individually, and to trusts for the benefit of each of petitioner's daughters, of which petitioners and another individual were the trustees.

Accordingly, after the conveyances, petitioner owned a 70 percent interest while the donees together owned the remaining 30 percent.

The Service determined deficiencies in federal gift tax against LeFrak and his wife for the taxable quarter ended December 31, 1976, in the amount of $342,658. The Service increased the deficiencies determined in the notice of deficiency by $73,229 for each petitioner.

The issues presented for decision in the case are as follows:

- a whether the interests transferred to several donees by petitioner Samuel J. LeFrak were interests in partnerships or in real property;
- b. the value of the buildings in which interests were transferred; and
- c. whether petitioners are entitled to a discount for minority interest and lack of marketability in valuing the transferred interests.

However, there was a dispute about the type of interest petitioner actually gave to the donees. LeFrak contends, and the Service respondent ("respondent") determined in the statutory notice of deficiency, that petitioner transferred partnership interests to the donees.

After the pleadings were filed, however, the Service respondent amended the answer to assert that LeFrak actually transferred fractional interests in the real estate, rather than partnership interests.

Respondent's contention is based on the fact that the deeds conveying the buildings named petitioner and the donees as grantees and that they held the buildings as tenants in common.

Respondent also argues that LeFrak's treatment of each of the transactions for financial, accounting, and tax purposes was consistent with a transfer of real estate, not partnership interests. Respondent contends that the buildings were conveyed to the partnerships subsequent to the gifts in issue, arguing that LeFrak was the sole owner of 20 of the buildings when he made the gifts.

The end decision ultimately allowed a 30 percent combined minority interest and lack of marketability discount for the subject undivided real estate interests.

9. *Estate of Alto B. Cervin v. Commissioner*.[15] This decision allowed a 20 percent fractional interest price discount for:
   - a. an undivided 50 percent interest in 657.3+/- acres of farmland and
   - b. an undivided 50 percent interest in a homestead.

10. *Estate of Eileen K. Brocato v. Commissioner*.[16] Eileen K. Brocato (the "decedent") died on April 12, 1993. At the time of her death, she resided in San Anselmo, California. The decedent was predeceased by her husband, Mr. John Brocato.

    Under the terms of Mr. Brocato's will, his estate passed into a testamentary trust for the benefit of the decedent until her death. Upon the decedent's death, the remainder of Mr. Brocato's estate was distributed predominantly to his sisters, Nina Cimarelli and Anne Ghiselli.

    Decedent's estate passed under the decedent's trust (the "Eileen K. Brocato Living Trust"). Under the terms of the decedent's trust, the decedent's grandchildren and the children of Nina Cimarelli and Anne Ghiselli received outright monetary gifts.

    The remainder was distributed as follows: one-third in trust for the benefit of Anne Ghiselli, one-third in trust for the benefit of decedent's son Thomas Brocato, one-sixth in trust for the benefit of Nina Cimarelli and one-sixth in trust for the benefit of her husband Alfred Cimarelli.

    At the time of death, the decedent's trust included eight apartment buildings and one duplex. The combined FMV before discounts was $10,432,000. The properties were appraised by David P. Rhoades & Associates, Inc. ("Rhoades").

On June 26, 1995, a Service engineer issued a review report concluding that the values before discounts determined by Rhoades were acceptable, but the amounts of the discounts were unacceptable. The Service determined a deficiency of $1,373,797 in estate tax.

The court eventually allowed a 20 percent fractional interest discount, but also had to resolve the proper amount of blockage discount to apply to the Brocato properties.

11. *Estate of Eileen K. Stevens v. Commissioner*.[17] The court allowed a 25 percent fractional interest price discount for an undivided 50 percent interest in commercial real estate subject to a lease.

    Specifically, the court determined that:

    a. the fair market value of the Kmart property was $5,300,000 and
    b. the decedent's 50 percent undivided interest had a value of $1,987,500 after a 25 percent lack of marketability discount.

    The 50 percent undivided interest in the Walgreens property had a fair market value of $1,335,000 before a 25 percent price discount, resulting in a tax return value of $1,001,250.

    Finally, the 50 percent undivided interest in the Wells Fargo property had a fair market value of $493,975 before a 25 percent price discount, resulting in a tax return value of $370,481.

12. *Estate of John L. Baird & Estate of Sarah W. Baird v. Commissioner*.[18] John L. Baird ("John") and Sarah-W. Baird ("Sarah") were husband and wife.

    At the time of their deaths on December 18, 1994, and November 2, 1995, John and Sarah held a 21.54 percent and 26.15 percent interests respectively in a family trust (created in 1977).

    The trust owned 16 noncontiguous tracts of Louisiana timberland. The trust was intended to keep the 16 parcels held by family members in undivided ownership.

    The trust provided for the sale of an interest, but only with the written consent of all of the beneficiaries.

    The 16 parcels ranged in size from 2 acres to 320 acres, and most of it was best suited as timberland. Approximately 140 of the 2,957 acres had some potential for residential development. Less than one-half of an acre had residential development as its highest and best use.

    John's estate reported the fair market value of his one-half community property interest in the 21.54 percent interest in the trust at $707,972, after applying a 25 percent fractional interest price discount.

    In an amended estate tax return, a refund was claimed on the basis of an increased fractional interest discount of 50 percent.

    After applying the 50 percent fractional interest price discount, the reported fair market value was $550,378 instead of $707,972.

    John's estate increased the price adjustment to 50 percent in response to the 50 percent used by Sarah's estate in determining the fractional interest value.

    The Service valuation expert (who was specifically found not to be qualified to assist the court) determined the date of death fair market value of John's 21.54 percent interest to be $975,091 and Sarah's 26.25 percent interest to be $1,290,211.

    The parties agreed that the fair market value of the 16 parcels of timberland, before price adjustments, on John's date of death was $4,685,333 and on Sarah's date of death was $5,091,285.

    The court allowed a 60 percent fractional interest price adjustment for John's 21.54 percent and Sarah's 26.15 percent fractional interests.

    In arriving at this fractional interest price adjustment, the court agreed with the taxpayer experts that 55 percent was the mean or average amount by which fractional interests in Louisiana timberland were discounted.

    The court further discounted the interests an additional 5 percent to reflect:

    a. the poor management of the subject property and
    b. disagreements among the remaining family members.

13. *Estate of Pearl I. Amlie v. Commissioner*.[19] A 15 percent fractional interest price discount was applied by the court to the taxpayer's 7/12ths and 50 percent interest in two parcels of farmland.

14. *Campanari v. Commissioner*.[20] At her death, the decedent owned undivided 113 interests in 5 parcels of real property in New York City.

    The taxpayer claimed the following valuation discounts: 12 percent for lack of control and 12 percent for lack of marketability.

    In the court's decision, both the lack of control associated with a fractional property interest and the lack of marketability of a fractional property interest are mentioned. However, these two valuation adjustments are not differentiated in the court's allowed overall price discount.

15. *Fawcett v. Commissioner*.[21] The subject interest was a 50 percent undivided interest in a ranch.

    The court agreed with a "reduction to reflect the undivided nature of the decedent's interest." However, the court combined the total price discount in with a number of other factors. This decision recognized the appearance of control despite the fact that the valuation subject was a fractional ownership interest.

16. *Gunn v. Commissioner*.[22] The subject interest was two 50 percent undivided interests in an apartment building owned by four people (two married couples). Upon the couple's divorce, the family law court awarded the husband and wife a 25 percent undivided interest each. The property could not be partitioned, and a sale of the property was ordered by the court. The court concluded that a price discount was not applicable.

17. *Mooneyham v. Commissioner*.[23] The subject interest was a gift of a 50 percent undivided interest in real property. The taxpayer claimed a price discount of 15 percent. The taxpayer did not make a distinction between the minority ownership position, the lack of marketability of a fractional interest, or the costs of partition, although all these factors are mentioned as being present.

    The court strongly criticized both the attorneys and the experts for presenting very poor substantiation of their arguments for price discounts.

18. *Pillsbury v. Commissioner*.[24] The decedent owned (1) a 77 percent undivided interest in one parcel of real property and (2) a 50 percent undivided interest in another parcel of real property. The taxpayer claimed a price discount of 15 percent on each parcel.

    Both the lack of control associated with a minority interest and the lack of marketability of a fractional interest are mentioned in the total judicial decision. However, these two valuation adjustments are not differentiated in the total price discount that was allowed by the court. The court refused to allow a price discount higher than the claimed discount of 15 percent.

19. *Van Loben Sels v. Commissioner*.[25] The decedent owned undivided interests in California in:

    a. certain real property and
    b. land, timber, and mineral rights.

    The taxpayer claimed a price discount of 60 percent.

    The court concluded that a minority interest discount is applicable to an undivided interest in real property just as in a closely held business. The court settled on a 60 percent discount for lack of control, but admitted to heavy emphasis on the lack of marketability of the undivided interests.

    The court provided a list of the "disabilities" of an undivided ownership interest:

    a. the number of other co-owners
    b. the time required to realize income from the land (use) and the return on the investment
    c. the time and cost to partition, and
    d. any prior sales of the subject undivided interest (and the estimated price discount on such sales).

20. *Whitehead v. Commissioner*.[26] The subject interest was a 50 percent undivided interest in a ranch. The taxpayer claimed a price discount of 14 percent.

    The judicial decision commented on the following factors:

    a. the lack of access to the subject property (i.e., the lack of a road)
    b. the effect of the impairment due to an undivided interest

    The weight given to these two factors in the allowed price discount was not explained in the judicial decision.

Summary and Conclusion

The valuation analyst may consider relevant judicial precedent in the fractional ownership interest

> **". . . the valuation analyst should not rely on . . . judicial precedent to reach a specific valuation discount conclusion."**

valuation. However, the valuation analyst should not rely on such judicial precedent to reach a specific valuation discount conclusion.

This is because the conclusion of a particular judicial decision is only relevant to the facts and circumstances of that case before that finder of fact. The facts and circumstances of the subject valuation analysis will typically be different from those considered in the judicial decision.

Therefore, the valuation analyst should apply generally accepted valuation approaches and methods when estimating the value of a real estate fractional interest. This discussion summarized:

1. the market approach and the sale transaction analysis method and
2. the income approach and the partition analysis method.

For a real estate fractional interest where a longer holding period is expected, the income approach may be the more appropriate valuation approach. This is because the income approach analysis incorporates many of the property-specific risk factors that affect value. And, in some cases, the expected holding period is better matched to a hypothetical buyer's investment objective.

For a real estate fractional interest where a shorter holding period is expected, the market approach may be more applicable to the fractional ownership interest valuation.

No matter which generally accepted valuation approach and method the valuation analyst decides to use, the appropriateness, accuracy, and quantity and quality of information should be considered in the final value reconciliation procedure.

Notes:

1. Don L. Harris, Philip A. McCormick, and W.D. Davis Sr., "The Valuation of Partial Interests in Real Estate," *ASA Valuation*, December 1983.
2. Martin J. Healy Jr., "Valuation of Partial Interests," *The Appraisal Journal*, July 1988.
3. Peter J. Patchin, "Market Discounts for Undivided Minority Interests in Real Estate," *Real Estate Issues*, Fall/Winter 1988.
4. Lance Hall, "Should the IRS Surrender Cost-to-Partition Discounts for Undivided Interests?" *Valuation Strategies*, January/February 1998.
5. Walter H. Humphrey and Bruce B. Humphrey, "Unsyndicated Partial Interest Discounting," *The Appraisal Journal*, July 1997.
6. Ted Israel, "Discounts on Undivided Interests in Real Estate," *Valuation Strategies*, May/June 2003.
7. *Estate of Forbes v. Commissioner*, T.C. Memo 2001-72 (Mar. 23, 2001).
8. *Estate of Williams v. Commissioner*, T.C. Memo 1998-59 (Feb. 12, 1998).
9. *Estate of Barge v. Commissioner*, T.C. Memo 1997-188 (Apr. 23, 1997).
10. *Shepherd v. Commissioner,* 115 T.C. 376 (2000).
11. *Estate of Della Walker van Loben Sels v. Commissioner*, T.C. Memo 1986-501 (Oct. 2, 1986).
12. *Estate of George W. Youle v. Commissioner*, T.C. Memo 1989-138 (Mar. 30, 1989).
13. *Estate of Wildman v. Commissioner*, T.C. Memo 1989-667 (Dec. 21, 1989).
14. *Samuel J. LeFrak v. Commissioner*, T.C. Memo 1993-526 (Nov. 16, 1993).
15. *Estate of Alto B. Cervin v. Commissioner*, T.C. Memo 1994-550 (Oct. 31, 1994).
16. *Estate of Eileen K. Brocato v. Commissioner*, T.C. Memo 1999-424 (Dec. 29, 1999).
17. *Estate of Eileen K. Stevens v. Commissioner*, T.C. Memo 2000-53 (Feb. 18, 2000).
18. *Estate of John L. Baird & Estate of Sarah W. Baird v. Commissioner*, T.C. Memo 2001-258 (Sept. 28, 2001).
19. *Estate of Pearl I. Amlie v. Commissioner*, T.C. Memo 2006-16 (Apr. 17, 2006).
20. *Campanari v. Commissioner*, 5 T.C. 448 (1945).
21. *Fawcett v. Commissioner*, 64 T.C. 889 (1975).
22. *Gunn v. Commissioner*, 49 T.C. 38 (1967).
23. *Mooneyham v. Commissioner*, T.C. Memo 1991-178 (Apr. 17, 1991).
24. *Pillsbury v. Commissioner*, T.C. Memo 1992-425 (July 27, 1992).
25. *Estate of Della Walker van Loben Sels v. Commissioner*, T.C. Memo 1986-501 (Oct. 2, 1986).
26. *Whitehead v. Commissioner*, T.C. Memo 1974-53 (Mar. 5, 1974).

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