

FAIR VALUE™

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USING BUSINESS VALUATION TECHNIQUES TO QUANTIFY DISCOUNTS FOR FRACTIONAL INTERESTS IN REAL ESTATE

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Introduction. It is quite common for an estate to hold an undivided fractional ownership interest as tenants in common in real property. The executors and the attorneys involved are often faced with the question of whether or not a fractional interest discount should be taken for estate tax return purposes and if so, how is it determined. The IRS has indicated it will consider the costs of partition, but that the burden falls on the taxpayer to substantiate such costs. Further, analysis of many cases relating to fractional discounts seems to show small discounts of between about 5% and 15%. Is such a small discount a correct indication of market realities? In most cases, rationally considering the range of outcomes in a partition to a buyer suggests this is not the case, but that discounts really ought to be higher in many circumstances.



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This article will summarize techniques that effectively and logically capture the size of a fractional discount and more accurately incorporate the true uncertainty associated with the pursuit of a partition.

The Partition Process. Under the North Carolina General Statutes, absent a desire by the other owners to sell, the only way a tenant in common may realize the fruits of the value of the underlying real estate is by seeking a partition. Under a "special proceeding" normally held before the local county Clerk of the Court, the Clerk appoints three independent "Commissioners Of Sale" whose job is to divide and apportion the property among the tenants in common.

The Commissioners, by statute, can be paid a reasonable fee, usually 5% of the total value of the property, plus incur costs for surveyors, appraisers, the dedication of streets and so on. The Commissioners have 60 days after their initial appointment to make their report, plus allowance for an additional 60 day extension. If the property is actually sold, which is often the case when there are disparate values among various holdings or if partition is not practical (such as a home), the sale procedure is that of a "judicial sale" as outlined in the North Carolina General Statutes. The option exists to seek either a public or private sale, although Clerks of Court often order a public sale under an auction to the highest bidder. This procedure follows the process of a 30 day advertisement period, followed by a 10 day upset bid period before the sale can be confirmed, with the minimum, non-appealed process taking about 3 months.

A tenant in common can appeal the findings of the Commissioners to Superior Court and the Court Of Appeals, and then later, to the North Carolina Supreme Court. According to a number of attorneys involved in partition actions, the entire process can take as little as three months, if uncontested, or last up to three years if a full appeal ensues. In the meantime, funds have to be expended by the party seeking partition for legal fees, surveying costs, appraisal fees, and other expenses.

Importance of the Time Value of Money. Since partition cases are not normally taken on a contingent fee basis, this means that the owner seeking partition will typically have to pay attorneys on a monthly basis as the partition proceeds. Thus, the investor who buys a fractional interest and then seeks partition may have to expend out-of-pocket cash resources throughout the process, a negative return, until

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ultimately realizing a positive inflow of cash from the property's sale. The present value timing impacts of these initial cash outflows followed by the later positive cash inflow must be captured in the valuation model to truly gauge the return implications of pursuing partition. Legal fees are certainly not the only costs incurred. Fees for surveyors and appraisers can be significant, not to mention the payments that must be made in the interim for property taxes, insurance, upkeep, and other similar costs.

Judicial Sale May Bring Less for the Property. Although the estate-planning attorney may have obtained an appraisal of the real property for estate return purposes, it is important to understand that the sale of a property at a public sale often results in a lower price. In a recent valuation we asked the real estate appraiser who determined the real property's appraised fair market value, which assumes an ample marketing period, to estimate what price the property would bring in a judicial forced sale which, by contrast, occurs quickly and "under the hammer." He estimated that the specific property would sell at a price that is 10% to 20% lower under those circumstances. Thus, the owner or investor who seeks to partition a property might ultimately receive a lower value for the property simply due to the forced nature of the judicial sale process.

Implications for Valuing the Fractional Interest. In summary, short of the unanimous desire by all parties to sell, the only way a non-controlling fractional interest can realize proceeds from a sale is via seeking judicial sale proceedings, where the property is either partitioned or sold, with proceeds distributed to the tenants in common. Even if such a procedure is undertaken, any distributions, whether in cash or in kind, are uncertain as to amount and the timing of receipt. Therefore, to properly gauge the potential returns and pricing of a fractional interest, the first step is to model the potential outcomes under best and worst case scenarios, along with the resulting value implications. This analysis must take into account the timing of the inflows and outflow associated with the process, the range of outcomes, and include a rate of return to the investor to compensate for the risk and uncertainty.

Income Valuation Approach Employed. Once a real property appraisal has been obtained, the fractional interest in real property can be valued using the income approach. The key to this methodology is the use of the so-called discounted cash flow valuation method. This involves forecasting the timing and amount of cash flows available to the owners. It takes into account the impacts of partition, including proceeds

available from the sale of real property assets under a public sale environment, the related outflows of expenses required while waiting for partition to occur, and the various legal, surveying and commissioner fees associated with the process. These can then be approximated under various scenarios (or outcomes) facing a potential acquirer of the ownership interest, such as those that follow:

- **Best case scenario-** involving an uncontested partition proceeding, which rapidly concludes with a distribution of proceeds to the respective owners.
- **Middle-of-the-road scenario-** involving an appeal of the partition proceeding from the Clerk of Court level to Superior Court.
- **Worst case scenario-** considering a protracted appeal of the partition proceeding from the Clerk of Court level to Superior Court, then to the NC Court of Appeals, and ultimately to the North Carolina Supreme Court.

From this range of values a final value for the fractional interest is determined. The buyer of a fractional interest in real property cannot be sure which outcome will occur, the exact amount of legal and other fees to be expended, or how long the process will actually take. Additionally, if the property is partitioned rather than sold, there is no guarantee that the portion of the property that the holder will receive will be choice or undesirable. Further, the parts, when separated, may be worth less individually than their summed values as a whole. These and other risks must be captured in two ways- the rate of return used to discount the timing of the inflows and outflows of cash in the partition process, and the range of outcomes used.

What About A Discount For Lack of Marketability? Note that the above methodology does not mention an additional discount for lack of marketability as is common in the valuation of business interests, or more specifically, limited partnership interests in partnerships which hold real estate. The cost of partition for a fractional share of real estate effectively constitutes the cost of liquefying the asset, that is, achieving marketability. Therefore, taking a discount for lack of marketability over and above the cost of partition would effectively be double-counting.

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A Final Caution. The techniques just described make practical sense. However, the tax case law involving quantifying the cost of partition is varied and uncertain. Therefore, this methodology should not be applied to specific circumstances except upon the advice of competent legal, tax and valuation counsel. ♦

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