



Valuation Perspectives

February 2007

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Discounting Undivided Interests in Real Property

A landmark Tax Court ruling pushed the discount ceiling well above 20%

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UNDER ARIZONA COMMON LAW, joint tenants each own an undivided whole of the property, whereas tenants in common have separate but undivided interests in the property. The important distinction is that the interest of a tenant in common is separate and is descendible, may be conveyed by will or deed, and can be encumbered, while a joint tenant's interest is in the whole and therefore is not descendible (i.e., the property passes to the survivor among the joint tenants) and cannot be conveyed or encumbered without affecting the rights of the other joint tenant.



In summary, the basic element of a tenancy in common is the single unity of possession (or the right of possession) of the common property by the various co-tenants. In a sense, each tenant in common owns an undivided interest in each square inch of the property.

Undivided interests discounted for lack of control and marketability. Two inherent characteristics of tenancy in common ownership – lack of *control* and lack of *marketability* – mitigate the value of an owner's undivided interest. No single co-tenant, whether minority or majority, can exercise unilateral control over management decisions related to the business and affairs of the property. Examples of matters subject to the vote of the tenants in common include, but are not limited to, financing, capital expenditures, distribution of income, and disposition of the property. Furthermore, there is no ready market for non-controlling undivided interests in real property. As a result, the owner

of a co-tenancy interest would be required to exert significant effort to find a buyer for its fractional interest.

Many attorneys, accountants, trust officers and financial planners believe it is not prudent to apply a discount to an undivided interest in excess of 20%. Their opinions are typically based on antiquated Tax Court decisions and IRS representations regarding the methodology that should be utilized by business appraisers when valuing undivided interests, including co-tenancy or tenant in common interests. Until the late 1990s, the IRS took the strict position, in accordance with its 1993 Tax Advisory Memorandum 9336002, that a discount applied to an undivided interest could not exceed the *pro rata* costs incurred by a co-tenant in a partition proceeding.

Tax Court allows 44% discount. General adherence to the 20% discount standard has eroded since February 12, 1998, when the Tax Court issued a landmark opinion in *Ellie B. Williams v. Commissioner* (TC Memo 1998-59). In that case, the court rejected using partition costs as the sole basis for discounting, in favor of the petitioner's argument that two distinct discounts should be applied to the co-tenancy interest, one for lack of control and the other for lack of marketability. The court essentially determined that the fair market value of a one-half undivided interest in unencumbered, undeveloped Florida timberland, which Ms. Williams gifted to a relative, is equal to 50% of the total equity in the property less a "blended discount" of 44%. The 44% discount represented a sharp departure from the 20% standard that was generally viewed as a safe harbor.

A factor cited by the Court in the *Williams* decision was the inability of the expert witnesses for both the IRS and the petitioner

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to find sales of fractional interests in comparable real property in Florida.

268 sales of undivided interests. Nine studies had been published since 1983 that theoretically quantify the blended lack of control and lack of marketability discounts reflected in 268 transactions involving undivided interests.

After analyzing the nine studies and 268 transactions, Ringel Kotzin Valuation Services has formed certain opinions that are discussed below.

First, the studies indicate an inverse relationship between the size of the discount and the blood relationship between the buyer and seller – that is, the closer the relationship between the buyer and seller, the smaller the discount. Therefore, it is apparent that such sales are not arm's-length transactions.

Also, the terminology used by the authors to report the blended discounts is inconsistent and sometimes misleading in the studies. Some of the more frequently used expressions are “discount from appraised value,” “discount as a percentage of market value,” and “discount to *pro rata* equity ratio.”

Third, in the studies in which the blended discount is characterized as a discount from appraised value or a discount as a percentage of market value, it is likely that some of the implied discounts are overstated because, in making their calculations, the appraisers ignored equity, a fundamental valuation concept. In other words, the authors of the studies failed to determine the market value of assets required to operate or maintain the property (cash equivalents, personal property, prepaid expenses

receivables, etc.) and add them to the appraised or market value of said property. Furthermore, they did not deduct the property's liabilities (mortgage, notes payable, tenant deposits, etc.) from the appraised or market value. Absent the aforementioned computations, which produce the co-tenant's *pro rata* equity in a property, it is not feasible to extract a blended discount from a sales transaction.

Finally, and surprisingly, the 268 transactions statistically support blended average discounts approximating 35% for both unimproved as well as improved properties. Assuming the properties with improvements on them are generating income to the co-tenants, one can intuitively conclude that many of the blended discounts must be skewed. Certainly, a hypothetical buyer would pay more for an undivided interest in an income-producing property than in an undivided interest in a vacant parcel of land. In summary, if it was plausible to isolate the arm's-length transactions in the studies that capture the *pro rata* equity ownership of the tenants in common, I am confident that the average blended discount for lack of control and lack of marketability associated with sales of undivided interest in improved properties that generate income would be substantially lower than the one evidenced by transactions in unimproved real estate that produce no income.

Based on my experience as a real estate appraiser, business valuator, and buyer of fractional interests in partnerships that own real property, it is my opinion that blended discounts approximating 30% and 40%, respec-

tively, should be applied to the controlling, marketable *pro rata* equity values of co-tenancy interests in income-producing and non-income producing properties. Of course, the appraiser must adjust the discount based on the specific facts and circumstances associated with the subject undivided interest. (The aforementioned methodology is known as the “asset approach to value.”) The valuator must also consider the income and market valuation methods when appraising a co-tenancy interest and then reconcile the value conclusions indicated by each approach in order to form a final and supportable opinion of value.

Estate and gift tax considerations. Ownership of undivided interests allows co-tenants to reduce the value of their estates and estate taxes.

If you own an undivided interest in real property, gifting the fractional interest is a tax-efficient strategy because it reduces the current value of your estate.

More important, unlike a transfer of a 100% fee simple interest in improved or unimproved property, the taxpayer enjoys the benefit of having a qualified appraiser apply lack of control and marketability discounts to the gifted co-tenancy interest.

Further, if the property in which the co-tenancy interest is owned appreciates after the date of the gift, the percentage of the subsequent increase in equity is also removed from your estate.

Finally, when a tenant in common interest in an income-producing property is gifted, the donor's portion of the earnings is, in effect, transferred to the donee. — Gary Ringel