

Chapter 11: Fractional Interests (Real Estate)

Real estate discounts are radically different from those adjustments for minority interests for privately held equity adjustments. The most important difference is the ability to force liquidation by owners of fractional interests in real estate. These adjustments are most associated with fractional interests in a land parcel or building. The main reason for the discount adjustment is the sharing of control.

Introduction

Most individuals simply assume that minority interests or fractional interests in real estate are identical or similar to partial interests in privately held businesses. The application of discounts for minority interest and marketability studies for privately held firms is not transferable to real estate.

A 100% undivided interest in real property can, in some ways, be compared to a 100% interest in the stockholders' equity of a company. A 100% ownership interest in a company will influence, among other things:

- the strategic direction that the company takes
- the election of officers and directors
- the disposition of assets
- the company's pricing or dividend policy

In the case of real property, a 100% undivided interest enables the owner to assume active management of the property or select the property management company; develop and/or sell the property; determine the amount of income distribution, if any; and dictate leasing terms, and so on.

Discount adjustments are usually applied by buyers for ownership interests which have concurrent ownership with another person. There are four basic types of concurrent ownership:

- (1) tenancy in common
- (2) joint tenancy
- (3) community property
- (4) tenancy in partnership

These different interests are summarized in Table 11-1.

Table 11-1: Summary of Typical Types of Real Estate Concurrent Ownership

Characteristics	Tenancy in common	Joint tenancy	Community property	Tenancy in partnership
Definition	An interest held by two or more persons, each having a possessory right in the same piece of property.	Where two or more persons are joint and equal owners of the same undivided interest in real or personal property.	All property acquired by husband and wife during marriage.	Two or more persons own property for partnership purposes.
Right of survivorship	No	Yes	Yes	Depends upon agreement
% Interests	Any fraction	Any fraction	50:50	Any fraction
Pros	Can easily force liquidation by appealing to court.	Survivor holds property free from debts of deceased tenant and from liens from tenant's interest.	Each spouse has right to dispose of his or her 1/2 interest by will.	Can easily force liquidation by appealing to court.
Cons	Shared ownership	Decedent may not want surviving joint tenant to get title free and clear; cannot give up interest by will; possible negative tax ramifications.	Neither may make a gift without the consent of the other; failure to dispose of spouse's 1/2 interest by will allows surviving spouse title free and clear.	Shared ownership

Before beginning a valuation assignment, it is important to know whether the interest being valued has a right of survivorship, meaning that if one joint tenant dies, the surviving joint tenant (or tenants) immediately becomes the sole owner. In general, if there is no right of survivorship, then some discount may be warranted. For a right of survivorship, a discount from the par value is questionable. Most discounts focus upon tenancies in common, due to there being no right of survivorship. As a result, the rest of this chapter will focus upon tenancies in common.

Liquidity

When parties hold property as co-tenants, each has an unrestricted right to possession and use of the property, so long as he or she does not exclude, or "oust," the others. Irreconcilable disagreements among the parties can be solved by: (1) partitioning the parcel by dividing it into separate properties, each of which is held in fee by only one of the former co-tenants; or (2) by selling it and dividing the proceeds; or gifting the interest.

Partition

First, if the property *can* be partitioned, then the land parcel or building will be sub-divided. *If this cannot* be done, or is infeasible, then there is a second solution.

The second solution is that each owner of a tenancy in common may sell his or her interest, transfer or will his or her interest separately from the other owners. The recipient of the interest then takes the place of the prior tenant and the tenancy in common continues as before. If the owners of the property are unable to agree among themselves as to the management of the property, then any one of them may apply to the Court for an order that the property be sold and that any profits from the sale be divided in the same proportion as each person's ownership interest in the tenancy. For example, it takes between 12-18 months in California to have a court liquidate the holdings of the tenants in common.

Forced Liquidation

An important difference between a partnership or business entity minority interest and a fractional interest in real estate is the difference of power to force liquidation. For example, in most states a 1% interest in a piece of real estate carries the same rights as a 99% interest holder. If the owner of the 1% interest is not satisfied, then he or she can force liquidation. This is not true for a 1% interest holding in a limited partnership, general partnership, or corporation.

1% & 99% Interests Have Equal Control

Both of the two alternatives discussed above may be costly and involve delays. Also, the risk that they will eventually become necessary often seems great, particularly when the co-tenants are unrelated. For these reasons, undivided interests are valued with an adjusted discount below their pro rata share of the fair market value of the overall property.¹

Obviously a buyer who seeks control and 100% ownership of the real estate would pay a market price for the real property. On the other hand, a potential buyer of a fractional interest would discount his or her purchase price from the par value in order to account for the shared control with the other fractional interest owners of a property. The rationale is that the buyer would want a higher or enhanced yield on his money in order to compensate him for the additional risk and lack of liquidity of the investment.

Discount Rationale

John Bogdanski, the author of *Federal Tax Valuation* cites two reasons for applying a discount to a fractional interest: (1) lack of a ready market of the proportionate interest (although forced liquidation is usually available); and, (2) forced sharing of control.

First, a hypothetical willing buyer might hesitate about entering into a co-tenancy relationship with one or more unfamiliar holders of fractional interests.

Hesitation of Buyers

Second, fractional interest discounts are often described as, or discussed in connection with, minority discounts, which reflect the lack of control inherent

Sharing of Control

1. Bogdanski, John A. Federal Tax Valuation (Boston: Warren, Gorham & Lamont), Section 5-5.

in minority shares in businesses. However, a key difference is that the discount is not related to the lack of control of a majority's interest over a minority interest. Even the owner of a "majority" undivided interest (e.g., a 90 percent undivided interest) must deal with the possession and use rights of the holder or holders of the other undivided interests (e.g., the holder of the other 10 percent). Therefore, unlike a majority block of corporate stock, a large-percentage undivided interest in real property does not bring with it opportunities for exclusive control.

The undivided-interest discount is not so much concerned with the lack of access to the property as it is with forced sharing of that access. Unlike minority shareholders, whose discounts are sometimes said to flow from their inability to affect management changes, all co-tenants are entitled by law to possess and use the co-owned assets (unless they abdicate these rights by agreement). It is the prohibition against "ouster" of other co-tenants that ultimately makes undivided interests less marketable than fee ownership, and not any inherent inability of a co-tenant to participate in the management of the subject property.

On the other hand, unlike minority shareholders, co-owners can force a partition or liquidation of the jointly held property, resulting in a severance of their ties from the other owners. To that extent, co-owners may have an advantage over minority shareholders in closely held corporations, who cannot compel liquidation.²

Variables Affecting Discount Size

A fractional interest discount reflects four variables:

- (1) the type of property
- (2) the cash flow of the property
- (3) the ability to partition the property, and the surveying and legal costs associated with a partitioning
- (4) the location of the property

Property Types

First, the type of property is important. Single family houses are more liquid than land parcels. In addition, fractional interests in income producing properties are more liquid than fractional interests in non-income producing properties, all things being equal.

Pre-Debt Versus Post Debt Discounts

Second and similarly, the amount of yield is important. Two ways of looking at yield need to be reviewed: (1) yield pre-debt and, and yield net of debt. For example, if a commercial property has a value of \$10,000,000, of which \$2,500,000 is equity, the net operating income (NOI) is 11% (pre-debt and pre-tax), and the debt service is for 30 years at 9% interest (assume fixed), then the equity return is 15% (debt service is \$60,346/month, or \$724,160/year. There-

2. Ibid, pp. 5.01 [2] [a] - [e].

fore, the post debt return is \$375,840 [$\$10,000,000 \times 0.11 - \$724,160$], or 15% [$375,840/2,500,000$]. As such, the capitalization rate is 11% while the equity yield rate is 15% (see Table 11-2 on page 257).

Now, if we conclude that the discount adjustment to be applied is 20% to a 35% fractional interest share, then the pre debt yield is 13.75%, with the equity yield being 18.79%. Obviously, this is a favorable yield for a potential buyer and there will probably be a lower discount made by the buyer. In summary, the higher the yield, the lower the discount and vice versa. This is the old “bird in the hand” maxim. As one begins to approach a 20-30% equity yield, then the discount begins to become questionable, since a proportionate interest in this investment is more easily marketable based on this higher yield.

Third, the ability to partition is based upon the economic viability of a partition. If a property is a small farm which cannot be operated profitably with less acreage, then its size may make partition a more difficult prospect than a fractional interest in a residential subdivision near a growing metropolitan area. As a result, a potential buyer would discount the value of the purchase price more in order to compensate him or her for this potential problem. **Partition**

Fourth, location is a major factor. Obviously if you are located within the commercial triangle of an affluent city, rather than the desert, then the discount adjustment will not be as severe. Locations can usually be analyzed through looking at transactions from different zip codes. **Location**

Overall, these items represent a degree of stigma in the minds of a potential buyer, and the impaired marketability associated with the fractional interest also influences the discount. **Summary**

Quantitative Studies

As mentioned earlier, one study looked at 54 transactions of undivided interests, with the discounts ranging from 0 to 82 percent and having a median of 35 percent.³ Another study looked at 21 transactions of fractional interests and found a range of between 5-94 percent, with a median discount of 30 percent.⁴ It must be noted that these discounts are pre-debt. In addition, there are problems with these studies since they are real estate limited partnership fractional interests and not tenancy in common fractional interests.

Discounts for fractional interests in real estate are generally between 15 percent to 20 percent below a pro rata proportion of the value of the total parcel (net of debt). According to information surveys provided by Frazier Capital (a

3. Peter J. Patchin, “Market Discounts for Undivided Minority Interests in Real Estate,” *Real Estate Issues* (Fall/Winter 1988), pp. 14-16.

4. Don L. Harris, Philip A. McCormick, and W.D. Davis Sr., “The Valuation of Partial Interests in Real Estate,” *ASA Valuation* (December 1983), pp. 62.73.