

VALUING UNDIVIDED INTERESTS IN REAL PROPERTY

Timothy C. Polacek, Esq.

Discount Appraisals.

Many professionals are surprised to learn that our firm prepares “*discount*” appraisals to determine the fair market value of undivided interests in real property. We routinely prepare these types of valuations for filing estate and gift tax returns and establishing purchase prices for transactions involving family members. For those familiar with our firm’s family wealth preservation and IRS audit practice areas, it should come as no surprise that we offer these services.

For years, we have assisted local attorneys, accountants, trust companies and other professionals in providing discount appraisals for all types of ownership interests. We do not compete with other attorneys in providing these services, but rather are an important part of the overall “valuation team” retained by a client. Because we are knowledgeable in understanding co-tenant, partner, member and shareholder rights, we can offer insight as to how these legal rights affect the value of an interest and whether these rights have been considered for valuation purposes.

Repairs and Maintenance.

It is often the case that an apartment or office building is in need of repairs to bring it to a saleable condition, but the underlying appraisal of the fee interest failed to adequately discuss these costs. In situations where children have inherited several properties, not only does obtaining a detailed property repair report inform them as to the expected cost to be incurred to maintain the property in a safe condition, but such a report may justify a reduction in value to reflect the property’s “as-is” condition.

EXAMPLE. We recently filed an estate tax return involving over 30 rental properties built in the 1970's. After an on-site analysis, needed repairs were estimated at \$950,000. This amount was included in our Section 6166 calculation and approved by the IRS.

Methods Used to Determine Discounts.

Data relating to sales of undivided interests is scarce. It is the rare case where there has actually been a sale of an undivided interest in the subject property. Thus, alternative approaches must be used to value the subject interest. In valuing undivided interests, the Tax Court has approved many methodologies, including a modified “**cost-to-partition**” approach. This approach involves a discounted cash flow analysis which examines the following factors:

- The time to complete a partition action

- Expected legal, appraisal, surveyor and other costs and timing thereof
- Expected brokers' commissions
- Likelihood of physical division of the property
- Likelihood of a higher or lower forced sale price
- Affirmative defenses available to the other owners
- The required rate of return for the subject interest and increased risk associated with partition
- The size and value of the subject interest

By analyzing these specific attributes of the property, a more tailored approach can be presented without having to resort to otherwise scarce "comparable sales." This approach usually results in larger discounts for smaller value interests and lower discounts for larger value interests, with the amount of the discount generally falling between 15% to 35%.

Other approaches can be used such as comparing the undivided interest to privately-owned real estate limited partnership interests and making adjustments to reflect the following factors:

- Yield and distributions
- Management
- Number and identity of co-owners
- Net asset value
- Investment size (dollars)
- Voting rights (including partition)
- Debt-to-equity ratio
- Market for trading

Support and Defense.

For over 45 years, our office has settled estate and gift tax audits with local IRS examining attorneys. We have established a solid reputation for thoroughness and respectability and are familiar with the IRS' methods in examining appraisal reports and challenging valuation discounts. If needed, we welcome the opportunity to work with you in resolving IRS tax controversies.

If you would like to review a sample appraisal report or discount appraisal pricing information, please contact us at (619) 239-7777 or TimothyPolacek@mmpph.com.