



Discounting Undivided (Partial) Interests

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Discounting Undivided Interests

- Overview:
 - What is an Undivided Interest?
 - History of Undivided Interest Discounts with IRS
 - An Examination of Key Court Decisions
 - IRS Position
 - Three Methodologies:
 - Undivided Interest Transactions
 - Adjusted Partnership Comparisons
 - Modified Cost-to-Partition

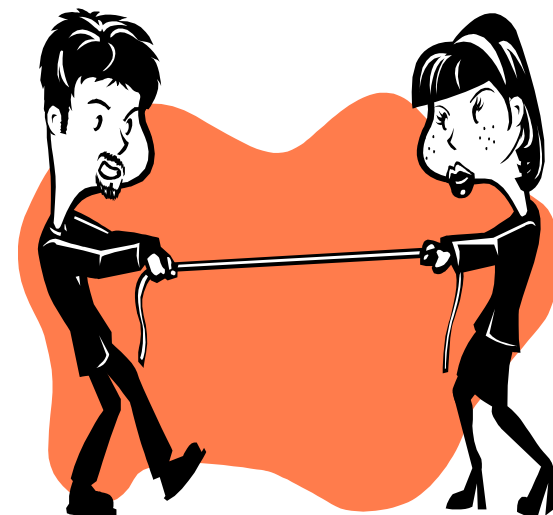


What is an Undivided Interest?

- A Form of Co-Ownership:
 - Tenancy-in-Common:
 - Community Property
 - Joint Tenancy (Right of Survivorship)
 - *Estate of Young*, No.20139-94 (May 11, 1998)
 - Section 2040(a)
 - Tenancy by the Entirety:
 - Married Couples
 - Primary Residence

What is an Undivided Interest?

- Rights of Tenancy-in-Common Owner:
 - Right to Occupy
 - Right to Use
 - Right to Lease
 - Right to Transfer Interest
 - Right to Partition
 - Partition in Kind
 - Partition by Appraisal (Cash-Out)
 - Partition by Sale (Licitation)





What is an Undivided Interest?

- Rights of Tenancy-in-Common Owner:
 - Right to Occupy
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 - Right to Partition:
 - Partition in Kind
 - Partition by Appraisal
(Cash-Out)
 - Partition by Sale (Licitation)

**All Rights Subject to
Same Rights
Accorded Other
Undivided Interest
Holders**

What is an Undivided Interest?

- Special Issues with Tenancy-in-Common Ownership:
 - Continuous Unanimous Consent (no control)
 - Every Interest Holder has Veto Power
 - Pass-Through Liability
 - Difficult to Borrow Against
 - Right to Cash Flow
 - Right to Partition Does Not Equal Liquidity:
 - Can Take 6 months to 5 years
 - By Sale – Forced Sale May Create Stigma
 - By Physical Partition – Complexities Make this Rare
 - By Appraisal
 - Disagreements on Appraisals
 - Wherewithal to Perform Buyout





History of Undivided Interest Discounts with IRS

- Three Time Periods:
 - Family Attribution Era
 - Cost-to-Partition Era
 - Post Cost-to-Partition Era



History of Undivided Interest Discounts with IRS

- Family Attribution Era:
 - Revenue Ruling 81-253
 - *Estate of Propstra*, Nos. 80-5424, 80-5430 (July 6, 1982)
 - *Mooneyham v. Commissioner*, T.C. Memo. 1991-178 (April 17, 1991)
 - Revenue Ruling 93-12
 - “Unity of Purpose” (Killed by *LeFrak v. Commissioner*, T.C. Memo. 1993-526 (November 16, 1993))



History of Undivided Interest Discounts with IRS

- Cost-to-Partition Era:
 - Technical Advice Memorandum 9336002 (May 28, 1993)

“...the amount of any discount should be limited to the petitioner’s share of the estimated cost of a partition of the property.”

History of Undivided Interest Discounts with IRS

- Post Cost-to-Partition Era:
 - IRS Retreat - Technical Advice Memorandum 199943009 (1999)
 - Focus on Fair Market Value Standard
 - Cost-to-Partition Relegated to “One Approach”





An Examination of Key Court Decisions

- Post 1993 TAM Court Case Discount Summary:

- *LeFrak* – 30%
- *Cervin* – 20%
- *Barge* – 26%
- *Williams* – 44%
- *Brocato* – 20%
- *Busch* – 10%
- *Stevens* – 25%
- *Wineman* – 15%
- *Forbes* – 30%
- *Baird* – 60%
- *Amlie* – 15%
- *Ludwick* – 17%

Mean = 26%

Median = 22.5%



An Examination of Key Court Decisions

- Excluded UI Court Cases:
 - *Estate of Young* – No. 20139-94 (May 11, 1998)
 - Joint Tenancy
 - Section 2040(a)
 - *Estate of Tehan* – T.C. Memo. 2005-128 (May 31, 2005)
 - Section 2036



IRS Position

- Ability to Partition Key Factor
- Must Consider Probability of Voluntary Sale
 - Post Valuation Date Sale
- Family Attribution
- *Propstra* Discount – 15%
- Discounts in Prior Court Cases
- Section 2036



Three Methodologies

- Undivided Interest Transactions
- Adjusted Partnership Comparisons
- Modified Cost-to-Partition



Three Methodologies

- Undivided Interest Transactions
 - Average Discount = 35.7 percent (median 34.0 percent)
 - Consider adjustments for:
 - Size of Interest
 - Number of Owners
 - Relationship of Remaining Owners
 - Income Producing
 - Property Type
 - Debt
 - Ownership Agreement
 - Appreciation Outlook

Three Methodologies

- Adjusted Partnership Comparison
 - Use Secondary Partnership Transactions
 - Sort Data:
 - If Appropriate Exclude:
 - Long-Term Triple-Net Lease Properties
 - Land Development Partnerships
 - Liquidating Partnerships
 - Consider:
 - Distributions to Net Asset Value
 - Size (Revenue, Net Asset Value)
 - Leverage (Debt-to-Total Adjusted Capital)



Three Methodologies

- Adjusted Partnership Comparison
 - Use Secondary Partnership Transactions
 - Consider Differences Between Partnerships and Undivided Interests:
 - Partnerships have a limited market (partial liquidity)
 - Adjust by Small Block/Large Block Restricted Stock Data
 - Adjust by Liquidating vs. Non-Liquidating
 - Partnerships register with SEC
 - Borrowing Difficulties (Buyer Must Pay Cash)
 - Undivided Interests Have Fewer Owners
 - Right to Sue for Partition
 - Unlimited Liability
 - Right to Cash Flow



Three Methodologies

XYZ Limited Partnership Comparative Ratio Analysis (000s omitted)

LPs by Revenues < \$3MM and Net Asset Values < \$15MM	Wells Real Estate Fund III-A, LP	Wells Real Estate Fund X-B, LP	Wells Real Estate Fund III-B, LP	Wells Real Estate Fund XI-B, LP	Rancon Income Fund I	Consolidated Capital Properties VI	XYZ Limited Partnership
	Office/Retail	Office	Office/Retail	Office	Lt Ind/Off	Apartment	Retail
	Dec-03	Dec-03	Dec-03	Dec-03	Dec-03	Dec-03	Dec-03
Primary Property Type:							
Latest Fiscal Year End:							
Revenues:							
2003	\$1,073	\$2,871	\$1,073	\$1,509	\$1,285	\$1,917	\$1,052
Funds From Operations							
2003	\$992	(\$281)	\$108	(\$218)	\$550	\$363	\$602
EBITDA:							
2003	\$992	(\$281)	\$108	(\$218)	\$550	\$768	\$602
Distributions to Limited Partners:							
2003	\$34	\$0	\$0	\$0	\$228	\$48	\$580
2003 LP Units Outstanding	19,635,965	336,541	2,544,540	266,027	12,966	181,300	NA
Market Value per LP Unit:							
2003	\$0.60	\$9.10	\$0.51	\$8.00	\$350.00	\$8.05	NA
Number of Transactions	4	1	1	2	1	1	NA
4th Qtr. Distributions per LP:							
2003	\$0.01	\$0.00	\$0.00	\$0.00	\$4.30	\$0.07	NA
Total Assets	\$13,791	\$21,204	\$13,791	\$14,038	\$4,721	\$5,663	\$8,415
Historical Portfolio Holdings	\$9,099	\$16,141	\$9,099	\$9,982	\$4,177	\$5,267	NA
Last Year's Hist. Portfolio Holdings	\$10,855	\$18,770	\$10,855	\$10,380	\$4,072	\$5,603	NA
Current Value Portfolio Holdings	\$11,428	\$2,090	(\$1,085)	\$1,772	\$6,990	\$9,177	\$8,000
Total Liabilities	\$601	\$1,293	\$601	\$654	\$118	\$5,457	\$72
Interest-Bear. Debt	\$0	\$0	\$0	\$0	\$0	\$5,026	\$0
Original Cost Capital	\$17,744	\$4,072	\$5,312	\$2,130	\$7,511	\$6,333	NA
Net Asset Value	\$14,355	\$4,273	\$1,842	\$3,271	\$7,416	\$4,116	\$8,344
Total Adjusted Capital	\$14,355	\$4,273	\$1,842	\$3,271	\$7,416	\$9,142	\$8,344
Market Value	\$11,782	\$3,063	\$1,298	\$2,128	\$4,538	\$1,459	NA



Three Methodologies

XYZ Limited Partnership

Comparative Ratio Analysis (000s omitted)

LPs by Revenues < \$3MM and Net Asset Values < \$15MM	Wells Real Estate Fund <u>III-A, LP</u>	Wells Real Estate Fund <u>X-B, LP</u>	Wells Real Estate Fund <u>III-B, LP</u>	Wells Real Estate Fund <u>XI-B, LP</u>	Rancon Income <u>Fund I</u>	Consolidated Capital <u>Properties VI</u>	XYZ Limited Partnership
Primary Property Type:	Office/Retail	Office	Office/Retail	Office	Lt Ind/Off	Apartment	Retail
Latest Fiscal Year End:	Dec-03	Dec-03	Dec-03	Dec-03	Dec-03	Dec-03	Dec-03
<u>Revenues/2003 Total Adj. Capital</u>							
2003	7.5%	67.2%	58.3%	46.1%	17.3%	21.0%	12.6%
<i>Revenue Growth 02-03</i>	<i>-43.3%</i>	<i>-16.1%</i>	<i>-43.3%</i>	<i>-10.7%</i>	<i>12.0%</i>	<i>-2.1%</i>	<i>5.1%</i>
<u>Funds From Operations/2003 NAV</u>							
2003	6.9%	-6.6%	5.9%	-6.7%	7.4%	8.8%	7.2%
<i>Funds From Operations Growth 02-03</i>	<i>6.1%</i>	<i>202.2%</i>	<i>-88.4%</i>	<i>74.4%</i>	<i>13.9%</i>	<i>-29.2%</i>	<i>-0.5%</i>
<u>EBITDA/2003 Total Adj. Capital</u>							
2003	6.9%	-6.6%	5.9%	-6.7%	7.4%	8.4%	7.2%
<i>EBITDA Growth 02-03</i>	<i>6.1%</i>	<i>202.2%</i>	<i>-88.4%</i>	<i>74.4%</i>	<i>13.9%</i>	<i>-17.9%</i>	<i>-0.5%</i>
<u>Distribution/2003 NAV</u>							
2003	0.2%	0.0%	0.0%	0.0%	3.1%	1.2%	7.0%
<u>Distribution Payout Ratio</u>							
2003	3.4%	0.0%	0.0%	0.0%	41.5%	13.2%	96.3%
<u>Indicated Div. Yld. (Ann. 4th Qtr.)</u>							
2003	6.7%	0.0%	0.0%	0.0%	4.9%	3.2%	NA
Debt/Total Adjusted Capital	0.0%	0.0%	0.0%	0.0%	0.0%	55.0%	0.0%
Total Liabilities/Total Adj. Capital	4.2%	30.3%	32.6%	20.0%	1.6%	59.7%	0.9%
Portfolio Growth	-16.2%	-14.0%	-16.2%	-3.8%	2.6%	-6.0%	NA
Appreciation	-19.1%	4.9%	-65.3%	53.5%	-1.3%	-35.0%	NA
Minority Interest Discount	-17.9%	-28.3%	-29.5%	-34.9%	-38.8%	-64.5%	NA



Three Methodologies

- Adjusted Partnership Comparison
 - Variation (Two-Step Approach):
 - Lack of Control
 - Lack of Marketability

Three Methodologies

- Adjusted Partnership Comparison
 - Two Step Approach Issues:
 - Lack of Control:
 - Don't use Closed End Funds for Lack of Control
 - Don't use Secondary FLP Data (not solely lack of control)
 - Use Public REIT Control Premium Inverse (adjust downward for less decision making issues)
 - Lack of Marketability:
 - Restricted Stock Companies More Volatile
 - Real Estate Generally Distributes More

Three Methodologies

- Modified Cost-to-Partition is Generally a Discounted Cash Flow Model
- Typical Assumptions:
 - Type of Partition (In-Kind/Sale/Appraisal)
 - Time Frame – Generally 6 months to 5 years
 - Terminal Value Growth Rate – Generally 0% – 10%
 - Costs:
 - Selling Costs (Commission/Closing)
 - Legal and Related Costs (Attorney/Referee/Title)
 - Appraisal Costs
 - Operating Cash Flows of the Property



Three Methodologies

- Modified Cost-to-Partition:
 - Discount Rate:
 - Discount Rate for Property (Capitalization Rate + Inflation), plus
 - Rate to Compensate Holder for Lack of Control and Lack of Marketability Over the Holding Period (Incremental Rate)



Three Methodologies

- Modified Cost-to-Partition:
 - Discount Rate:
 - Incremental Rate Determination
 - Small Block Restricted Stock IRR Premium Determination
 - Liquidating Partnership IRR Premium Determination



Three Methodologies

- Reconciliation of Approaches
- Sanity Check



Questions?

Speaker Biography



Philip M. Schwab, ASA is a Managing Director at FMV Opinions, Inc. in the firm's Orange County, California, office and has significant responsibility for the firm's national valuation discount group. Mr. Schwab has extensive experience in determining discounts for lack of control and lack of marketability for fractional interests in real property and for interests in business entities that hold real property, marketable securities, and other traditional and nontraditional assets. He is also recognized for his expertise in determining the valuation impact of holding investment assets inside a C corporation as well as valuing nonvoting securities, debt instruments, and other nontraditional business interests. Mr. Schwab, who has been with FMV since 1996, has performed valuations involving a wide variety of property types and operating businesses for purposes that include estate taxes, gift taxes, income taxes, litigation support, employee stock ownership plans, and corporate planning.