

# CALIFORNIA SOCIETY OF CPA'S Marina Del Rey, CA

Fractional Interest Discounts  
October 19, 2011



IRS LARGE BUSINESS AND  
INTERNATIONAL DIVISION

# Welcome

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Thank you to the California Society of CPAs for inviting us to your meeting today.

Our goal for the day is to inform and strengthen our working relationships.

**Neil B. Mills-Mazer**  
**Engineering and Valuation**  
**Team Manager, Los Angeles, CA**

**Degrees and Licenses: BS, JD, AVA**

**Work Experience:**

**23 years with IRS**

**Revenue Agent, Appeals Officer,  
Financial Products Specialist,  
Business Valuation Specialist,  
Team Manager**

**Responsible for review and  
concurrence on all valuation  
reports issued by my team.**

**Support valuation issues at all  
levels – examination, appeals  
and trial.**

**Areas of emphasis include  
Appraiser Professional  
Responsibility, Non-cash  
Charitable Contributions and  
Research Credit**



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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**Presented by:**

**Neil B. Mills-Mazer, JD, AVA  
Los Angeles, CA**



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **METHODOLGIES WE'VE SEEN**

- 1. ACTUAL TRANSACTIONS**
- 2. REAL ESTATE PARTNERSHIP DATA**
- 3. COST TO PARTITION**
- 4. IPO/RESTRICTED STOCK STUDIES**
- 5. COURT CASES**

# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **PROBLEMS WITH ACTUAL TRANSACTIONS**

- 1. NOT THE SAME TYPE OF PROPERTY**
  - a. Farmland vs Timberland vs  
Commercial Property vs Residential**
- 2. OLD DATA**
  - a. Over 50 years**

# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **PROBLEMS WITH ACTUAL TRANSACTIONS (Cont.)**

- 3. COMPLEX TRANSACTIONS**
  - a. Over 10 Interests**
  - b. Lease or other Incentives**
- 4. INCOMPLETE FACTS**
- 5. RELATED PARTIES**

# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **PROBLEMS WITH ACTUAL TRANSACTIONS (Cont.)**

**THEY ONLY DEAL WITH A SALE OF A  
PARTIAL INTEREST TO ANOTHER.**

**WHAT ABOUT THE OPPOSITE  
TRANSACTION - SELLING A 100%  
INTEREST TO TWO OR MORE  
FRACTIONAL INTERESTS?**

# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **PROBLEMS WITH REAL ESTATE PARTNERSHIP DATA**

**THEY DON'T CARRY THE SAME RIGHTS  
AS TENANTS IN COMMON**

- 1. RIGHT TO PARTITION**
- 2. SHARED MANAGEMENT AND CONTROL**





# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **PROBLEMS WITH COST TO PARTITION**

- 1. UNDERLYING PROPERTY IS UNDERVALUED**
- 2. GROWTH RATE (MARKET CONDITION ADJ.)  
LONG-TERM VS SHORT TERM RATES**
- 3. YEARS TO PARTITION OVERSTATED**

# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **PROBLEMS WITH COST TO PARTITION (Continued)**

- 4. CASH FLOWS DURING PARTITION PERIOD**
  - a. RENTAL VALUE UNDERESTIMATED**
  - b. PROPERTY TAXES (PROP 13)**
- 5. DISCOUNT RATE**



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **WHY WE LIKE COST TO PARTITION**

**IT REPRESENTS THE REALITY OF WHAT THE  
PRESENT INTEREST HOLDER WOULD  
RECEIVE**

**SANITY CHECK:**

**CONSIDER IF THE PROPERTY CAN BE  
PHYSICALLY PARTITIONED**

# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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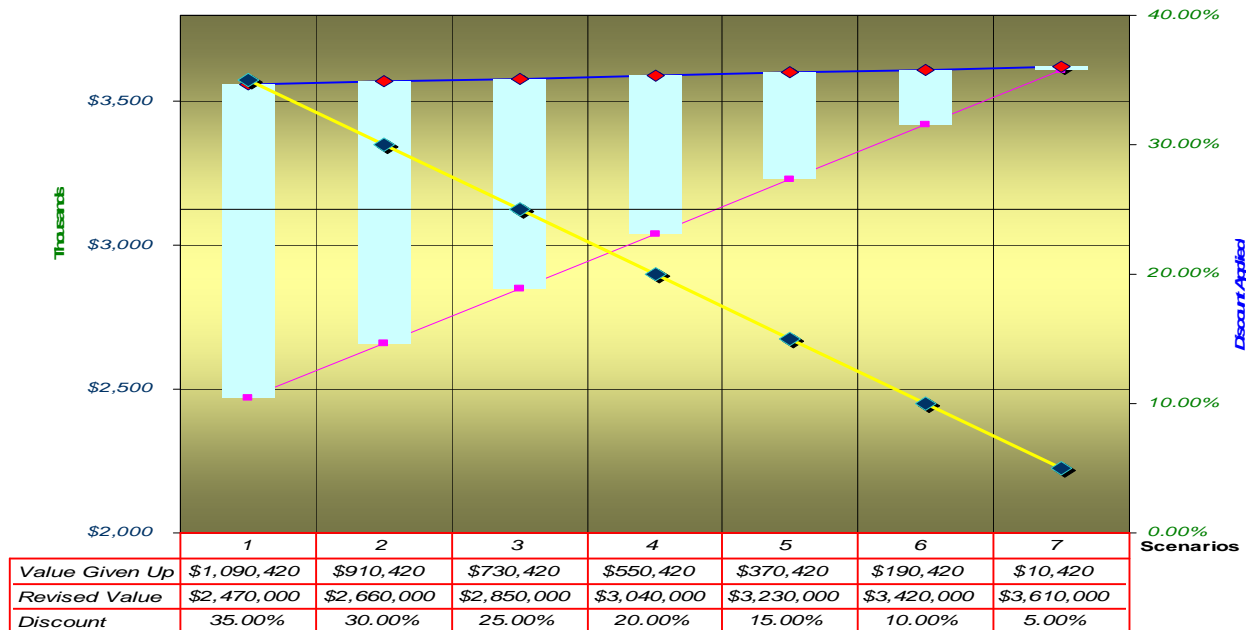
## **WAIVER OF RIGHT TO PARTITION**

- 1. LEGALITY –**
  - a. ADEQUATE CONSIDERATION**
  - b. ENFORCEABILITY**
- 2. VALUE –**
  - a. IMPLIED GIFT?**

# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## WAIVER OF RIGHT TO PARTITION

Relationship of Value Given up to Discount Percentage



# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

		Interest Holders	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	35.00%	\$1,330,000	\$1,330,000
		\$2,470,000	\$1,530,000

Indicated Premium for Minority Interest Holder 665.00%

# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

		<u>Interest Holders</u>	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	20.00%	\$760,000	\$760,000
		\$3,040,000	\$960,000

Indicated Premium for Minority Interest Holder 380.00%

# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

		<u>Interest Holders</u>	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	5.00%	\$190,000	\$190,000
		\$3,610,000	\$390,000

Indicated Premium for Minority Interest Holder 95.00%



# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

		<u>Interest Holders</u>	
		95.00%	5.00%
Property Value	\$4,000,000	\$3,800,000	\$200,000
Discount Allowed	3.00%	\$114,000	\$114,000
		\$3,686,000	\$314,000




Indicated Premium for Minority Interest Holder 57.00%

# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

Discount Allowed	Minority Interest									
	1.00%	5.00%	10.00%	15.00%	20.00%	25.00%	30.00%	35.00%	40.00%	45.00%
1.00%	99.00%	19.00%	9.00%	5.67%	4.00%	3.00%	2.33%	1.86%	1.50%	1.22%
5.00%	495.00%	95.00%	45.00%	28.33%	20.00%	15.00%	11.67%	9.29%	7.50%	6.11%
10.00%	990.00%	190.00%	90.00%	56.67%	40.00%	30.00%	23.33%	18.57%	15.00%	12.22%
15.00%	1485.00%	285.00%	135.00%	85.00%	60.00%	45.00%	35.00%	27.86%	22.50%	18.33%
20.00%	1980.00%	380.00%	180.00%	113.33%	80.00%	60.00%	46.67%	37.14%	30.00%	24.44%
25.00%	2475.00%	475.00%	225.00%	141.67%	100.00%	75.00%	58.33%	46.43%	37.50%	30.56%
30.00%	2970.00%	570.00%	270.00%	170.00%	120.00%	90.00%	70.00%	55.71%	45.00%	36.67%

### LEGEND

-  Range of Premium considered reasonable (between 20% to 35%)
-  Range of Premium considered too large (over 35%)
-  Range of Premium considered too low (under 20%)



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **MINORITY PREMIUM**

**CAN WE TAKE ANY OF THIS IN  
APPLYING A DISCOUNT TO A  
50%/50% FRACTIONAL INTEREST?**



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **MINORITY PREMIUM**

**LAST COLUMN IN SPREADSHEET -**

**A MAXIMUM 30% DISCOUNT IS  
INDICATED!**



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **MINORITY PREMIUM**

**CAN WE TAKE ANY OF THIS IN  
APPLYING A DISCOUNT TO THE  
MINORITY FRACTIONAL INTEREST  
HOLDER?**



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **MINORITY PREMIUM**

**SOME WEIGHT SHOULD BE APPLIED  
SINCE THE PREMIUM THAT THE  
MAJORITY CAN OFFER TO THE  
MINORITY MIGHT ENCOURAGE A  
SALE.**

# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

Method	Indicated Discount	Indicated Value	Weight	Weighted Value
<b>Actual Transactions</b>				
Fractional to Fractional	28.00%	\$2,736,000	4	\$109,440
Whole to Fractional	0.00%	\$3,800,000	5	\$190,000
<b>Cost-To-Partition</b>				
Present Holder	28.00%	\$2,736,000	4	\$109,440
Hypothetical Buyer	31.00%	\$2,622,000	2	\$52,440
<b>Minority Premium</b>	3.00%	\$3,686,000	85	\$3,133,100

Total 100 \$3,594,420

Indicated Discount 5.41%

Rounded Value **\$3,594,000**

Total Underlying Value of Property	\$4,000,000
Percentage of Ownership	95.00%
Value of Ownership	<u><u>\$3,800,000</u></u>

# METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

## MINORITY PREMIUM

Method	Indicated Discount	Indicated Value	Weight	Weighted Value
<b>Actual Transactions</b>				
Fractional to Fractional	28.00%	\$576,000	25	\$144,000
Whole to Fractional	0.00%	\$800,000	25	\$200,000
<b>Cost-To-Partition</b>				
Present Holder	28.00%	\$576,000	30	\$172,800
Hypothetical Buyer	31.00%	\$552,000	15	\$82,800
<b>Minority Premium</b>	<b>3.00%</b>	<b>\$776,000</b>	<b>5</b>	<b>\$38,800</b>

Total 100 \$638,400

Indicated Discount 20.20%

Rounded Value **\$638,000**

Total Underlying Value of Property \$4,000,000

Percentage of Ownership 20.00%

Value of Ownership \$800,000





# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **CONCLUSION**

***UNDIVIDED INTEREST TRANSACTIONS***

*FRACTIONAL TO FRACTIONAL*

*WHOLE TO FRACTIONAL*

***COST TO PARTITION APPROACH***

*PRESENT HOLDER ASSUMPTIONS*

*HYPOTHETICAL BUYER*

***MINORITY PREMIUM APPROACH***



# **METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS**

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## **CONTACT INFORMATION**

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# Questions



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