Partial interests in real property: Does the sum of the parts equal the whole?

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by Richard M. Wise, Partner, and Andrew Yas, Consultant MNP SENCRL, srl LLP

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the subject property on the market or list it for sale with a real estate agent or broker; nor can he/she cause periodic cash distributions to be made. The undivided co-ownership interest comprises a “bundle or rights” and not the property itself.

Valuation of Partial Co-Ownership Interests
The Québec Civil Code3 ("QCC") addresses undivided co-ownership.

The basic premise supporting a discount for a partial co-ownership interest includes the "forced" sharing of control. If, for example, there are disagreements between or among the parties concerning the use or management of the property, there are two alternatives:

1. partition, which involves dividing the property into separate properties, each of which is held as a fee interest by only one of the parties (a former co-owner); or
2. sale of the property and division of the proceeds of disposition.

Unlike valuing a minority interest of a shareholder in a corporation — a two-step process in which one discount is applied for lack of control (minority discount) and another discount for lack of marketability (marketability discount) — the basis for calculating the discount on a partial co-ownership interest is viewed as a one-step process with respect to which the two discounts are combined. This is because there is no active public market, such as a securities exchange, in which a comparison of minority discounts can be made based on open-market transaction data. Moreover, the control issues are different. The undivided co-ownership interest discount does not result from the potential imposition of the majority’s will over that of the minority, absent an agreement to the contrary.

The U.S. Tax Court has distinguished between (1) lack of control (i.e., minority interest) and (2) lack of marketability discounts for an undivided interest in real estate:

“ ... A minority discount for an interest in real property may be allowed on account of the lack of control which accompanies coownership. [*] ... However, a holder of a fractional interest in a real property has the power to compel partition of property, which is not available with other types of shared ownership interests. [*] ... We have on several occasions considered the cost, uncertainty, and delays attendant upon partition proceedings as the basis for allowing a discount in valuing fractional interests in real property. [*] ... The marketability discount, by contrast, measures the diminution in value attributable to the lack of a ready market for the property. [*] ... “5 [* Citations omitted.]

An owner of a partial co-ownership interest in real property is not afforded the types of protection given to minority shareholders under the provisions of the company law statutes, such as a dissent remedy and oppression remedy.6

There are three valuation approaches that are generally considered in valuating an undivided co-ownership interest:

1. Undivided Interest Discount Approach;
2. Real Estate Limited Partnership Approach; and
3. Cost to Partition.
In applying the first approach, the valuator must, as a minimum, explain how the discounts had been arrived at and identify how any specific transactions relied upon were (or were not) comparable to the interest being valued.

It is generally accepted that a hypothetical purchaser would not demand a discount greater than the cost and likelihood of partition and the marketability risk. If the matter is litigated, the court may determine the likelihood of partition, length of time and attendant costs to partition the property, as well as a hypothetical buyer's required rate of return.

The United States Tax Court, after hearing the expert evidence led on behalf of the taxpayer and the U.S. Internal Revenue Service, concluded that a contested partition would take two years, including one year to sell the property, and would cost 1% of the U.S. $7.25 million value of the property. Also, a buyer would expect partition 10% of the time and would require a 10% return on investment. Selling costs of 6% of the property's fair market value plus one-half of its annual maintenance costs were also deducted. The Court held that the fair market value of a one-half undivided co-ownership interest in the $7.25 million property was $2.70 million if partition is assumed and $3.00 million assuming no partition. Based on the assumption that a partition would occur only 10% of the time, the Court arrived at slightly over $3.00 million for each of the 50% co-ownership interests, resulting in an effective partial-interest discount of 17%.

Lack of Control
By not being able to exercise control over the property itself, an informed, willing, arm's length purchaser of the co-ownership interest would be unable to unilaterally:

- direct overall management policy and objectives;
- formulate policies relating to the timing and distribution and/or withdrawal of profits; and/or
- cause the sale the property.

The size of the discount for lack of control would consider the facts and circumstances in each case, which include, among others:

- the size of the co-ownership interest;
- the relationship among the co-owners;
- whether group control exists;
- whether or not there are special purchasers in the marketplace; and
- the terms of the co-owners' buy-sell agreement, if any.

Marketability/Liquidity
The concept of marketability relates to the relative ease and certainty with which an expected value can be obtained for a business, business ownership interest or security in its typical market, when desired, and the relative promptness with which the business interest or security can be converted into cash or into a replacement asset.

The factors considered in quantifying a marketability discount on a non-freely-traded investment include, among others:

- rates of return prevailing in the marketplace at the valuation date;
- the holding period of the co-ownership interest;
- distributions during holding period;
- capital appreciation during the holding period;
- the nature of the property (commercial, industrial, residential);
- management;
- restrictions on transferability;
- whether there is a buy-sell or "put" provision with respect to the interest; and
- likelihood and/or imminence of a sale of the property ("liquidity event").

Possible data sources for determining the discount on non-freely-traded investments include:

(a) direct sales of partial co-ownership interests;
(b) partition-time data and partition-cost data;
(c) restricted stock studies;
(d) pre-initial public offering ("IPO") studies; and
(e) options trading models.

A number of published empirical studies in the U.S. have quantified the discounts on undivided interests in real property based on surveys of arm's length sales of partial co-ownership interests. The sources in (a) and (b) above are addressed in the ensuing pages.

Direct Sales of Partial Co-Ownership Interests
Applying this method, the applicable discount is developed by analyzing the sales of partial co-ownership interests in comparable properties. However, the Direct Transactional Sales Method is often difficult, or not possible, to apply because there are often insufficient meaningful local data on which to base a comparison to support the discount. Questions arise as to the true "comparability" of the properties
used. There is generally no market for partial co-ownership interests in real property other than the other co-owners, who will likely demand a heavy discount to be applied as “price-setting” buyers.

**Partition-Time Data and Partition-Cost Data**

These data are used in developing the partial-interest discount by measuring the time and cost required to partition a property through a forced sale by taking legal action.\(^1\) The partial-interest holder will realize his or her pro-rata share of the whole, but must bear the costs.

The fact that a co-owner may have the right to bring a lawsuit to force the partition or sale of the property and distribution of the proceeds can often reduce the partial-interest discount. While the partition action would force the sale and division of the asset(s), there may be different scenarios to be considered, such as:

- The co-owners could agree to sell the property, eliminating the need for a lawsuit.
- The legal process may be simple, requiring less than a year to judgment, and involving nominal fees. The process becomes increasingly more difficult and expensive, however, as the number of co-owners increases and/or as the relationship among the co-owners becomes more disharmonious as demonstrated in a case before the Québec Superior Court.\(^1\)
- A partition-in-kind could be effected, depending on the physical attributes of the property. For example, vacant land can easily be subdivided, but costs associated with subdividing and also any change in highest-and-best-use between the larger parcel and the resulting smaller parcels must be considered.

In Technical Advice Memorandum 9336002,\(^2\) the U.S. Internal Revenue Service states that if a discount is warranted for a partial co-ownership interest in property, the discount should be limited to the estimated cost of a partition of the property. However, the IRS does not express its opinion as to whether an additional discount from a pro-rata portion of the fair market value of the entire property was appropriate in such case. This may possibly allow for such a discount under certain specific circumstances. Circumstances appear to warrant such a discount in IRS Technical Advice Memorandum 9718004,\(^3\) where the U.S. taxation authorities recognized that partial-interest discounts are not always limited to partition costs.

The discount for a partial co-ownership interest in real property is based on several factors. In addition to the costs of partitioning the land, the following factors would also influence the size of the discount:

- The size of the partial co-ownership interest: smaller interest — larger discount;
- The number of owners: more owners — larger discount;

### IBA and OECD join forces to develop practice guidance to equip lawyers in fight against corruption

Following on from the London Anti-Corruption Summit which took place in May 2016, the International Bar Association (IBA) and the Organisation for Economic Co-operation and Development (OECD) have agreed to form a task force to develop professional conduct standards and practice guidance for lawyers involved in establishing and advising on international commercial structures and recommended actions for governments. The principle motivation for forming the OECD-IBA Task Force on The Role of Lawyers and International Commercial Structures is to create a key component in the global fight against corruption. The release earlier this year of the so-called Panama Papers highlighted that, in completing legal transactions for their clients, lawyers may knowingly or unwittingly assist clients in asset concealment or money laundering. International standards, such as the Recommendations of the Financial Action Task Force (FATF), provide a framework for conducting due diligence on customers and identifying the beneficial owner. However, countries’ implementation of these standards has been variable. Since the scandal, many governments have called for greater transparency of such transactions, sometimes requiring reporting by lawyers. At the same time, lawyers are mindful of their professional obligations of confidence to their clients. The Task Force will work to develop appropriate guidance with respect to forming international commercial structures, while ensuring that confidence in both the lawyers’ role and the core principles of the legal profession are preserved.
• The size of the tract (i.e., practicality of partition): smaller tracts — larger discount;
• The use of the land: farmland — larger discount; and
• Availability of financing for undivided interests: tighter financing — a larger discount.

Factors Considered in Calculating the Discount
The following discount/risk factors with respect to the property or a partial co-ownership interest therein, as the case may be, would be considered by an informed, knowledgeable, arm’s length, uncompelled purchaser in the notional marketplace, as applicable:

(a) the interest comprises rights or interests in and to the property, and not a portion thereof, i.e., it represents a bundle of rights and not the real estate per se or an identifiable fraction thereof;
(b) there may be no buy/sell agreement or put arrangements among the co-owners of the property;
(c) the co-owner lacks control over the property;
(d) the interest is illiquid and not readily marketable, i.e., there is no ready, active or organized market;
(e) there is no indication that a sale of the entire property is imminent;
(f) partition would involve a lengthy, drawn out and expensive process, requiring substantial legal fees perhaps at both the trial court and appellate court levels;
(g) there is no assurance that the notional purchaser would receive distributions on a timely basis, as the vendor may have done in the past;
(h) although the market for the interest includes the other co-owners, there is no compulsion on any of the others to acquire it;
(i) even if the other co-owners would wish to acquire the interest, they would have no reason to offer more than a slightly nominal amount over what other arm’s length parties (“ordinary” purchasers) might offer should the interest be placed on the market;
(j) banks generally do not grant loans to owners of partial co-ownership interests without the consent of the other co-owners;
(k) the interest might have “nuisance value”;  
(l) there might possibility be a change in use of the property; and
(m) there may be interim cash flows/distributions made (or not made) up until the liquidity event occurs.

Thus, while the appropriateness of discounts is well established, courts and tax auditors are increasingly stressing the quality of partial-interest discount calculations in determining the size thereof. Courts want valuators to carefully address the relevant issues that affect the value of a partial co-ownership interest and substantiate any discount applied, particularly if the discount exceeds 15%.

Partial-interest discounts apply not only to real property, but to other types of assets such as (but not limited to) intellectual property, art collections, jewellery, libraries, aircraft and vessels, etc.

The importance of partial-interest discounts is not only recognized by the courts, but also by business valuation professionals. The American Society of Appraisers has issued a Procedural Guideline entitled, “Valuation of Partial Ownership Interests”, listing the factors to consider as well as related approaches, methods and procedures.