



## Judicial Opinions Regarding Fractional Interests in Real Estate

This article presents an overview of several recent judicial opinions regarding appropriate discounts for fractional interests in real estate. Fractional interests in real estate result from a property owner's ownership of less than 100% of a given property. Generally, the owner of a fractional interest has the right to partition, the right to a pro rata share of income, and veto power over decisions concerning the use or disposition of the property. Ultimately, state laws determine the bundle of rights available to the owner of a fractional interest. Common sense and numerous judicial opinions tell us that a fractional interest in real property is worth less than the interest's pro rata portion of the total property value. For property owners, their advisors, and appraisers, the issue is determining what discount to the interest's pro rata portion of the fee simple property value is appropriate.

To support an appropriate discount for a fractional interest, two appraisals will likely be required. The first step is to obtain a credible real estate appraisal for the underlying property. Because most real estate appraisers are not experienced in valuing fractional interests, the next step is hiring a valuation professional who understands valuation methodologies and how they apply to fractional interests.

**IRS Position.** In issuing deficiency notices, the IRS frequently attempts to limit the amount of the fractional interest discount to the cost to partition the property; however, the *IRS Training Manual for Appeals Officers Coursebook* recognizes several factors that could influence the size of the discount. The following factors are listed in the *Coursebook*:

- » The size of the fractional interest;
- » The number of owners;
- » The size of the tract;
- » The use of the land;
- » Availability of financing for undivided interests; and,
- » The costs of dividing the land (partition).

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**Judicial Opinions.** Generally the courts have concluded that fractional interest discounts are appropriate in determining the fair market value of a fractional interest in real estate. The table below shows several recent Tax Court Memorandums that applied fractional interest discounts based upon the facts and circumstances of the particular case. As can be seen in the sample below, a wide range of fractional interest discounts have been allowed.

TC MEMO	PETITIONER'S NAME	FRACTIONAL INTEREST	FRACTIONAL INTEREST DISCOUNT
1997-188	Barge	25% Interest in Timberland	26%
1998-59	Williams	50% Interest in Timberland	44%
1999-424	Brocato	50% Interest in Apartments	20%
2000-3	Busch	50% Interest in Residential Development Properties	10%
2000-53	Stevens	50% Interest in Commercial Property	25%
2001-72	Forbes	42% & 42.9% Interest in Two Parcels of Land	30%
2001-288	Baird	26% Interest in Timberland Held Through a Family Trust	60%
2006-76	Amlie	56% and 50% Interests in Two Parcels of Land	15%

The following discussion presents brief summaries of these recent Court decisions.

At issue in *Estate of Bonnie I. Barge v. Commissioner* was a 25% undivided interest in timberland that was gifted in 1987. The parties stipulated that the fee simple value of the timberland was \$40 million at the valuation date. The Court determined that the undivided interest could be liquidated or turned into a fee interest within four years by way of an action for partition. After estimating the monetary costs and benefits over the four year period, a discounted cash flow analysis at a 10% rate found the value of the 25% fractional interest was \$7,404,649.

A 1998 Tax Court decision rejected the Service's argument that a discount no larger than 5% should apply because petitioner offered no evidence of actual sales of fractional interests in real property. In *Estate of Williams v. Commissioner*, the Court held that banks generally will not lend money to the owner of a fractional interest in real property without the consent of the co-owners and that the inability to find sales of fractional interest in comparable searches shows that there was no market for fractional interests in such property.

In *Estate of Brocato v. Commissioner*, decedent owned nine apartment properties, three in which ownership was 50%. The court allowed an 11% blockage discount on seven of the properties that were similar. For the three properties in which decedent owned a 50% interest, the Court considered the size of the interest, the lack of a market for the interests, special circumstances surrounding the sale, and whether there would be a forced sale in determining the proper fractional interest discount. The Court rejected the Service's argument that the fractional interest discount should be no more than the cost to partition.

... many judicial opinions support discounts greater than the costs of partition in determining fair market value for fractional interests in real estate based upon the facts and circumstances prevailing at the valuation date

A case in which the court did not agree with either party's real estate appraisal or fractional interest discount involved a 50% interest in 90.74 acres in Alameda County, California in *Estate of Busch v. Commissioner*. Because of numerous facts and circumstances the Court determined the fee simple market value of the property and applied a 10% fractional interest discount.

In *Estate of Stevens v. Commissioner*, the Court stated, "We do not limit the discount to the costs of partitioning because such a discount does not account for the factors of control and marketability in the circumstances of this case."

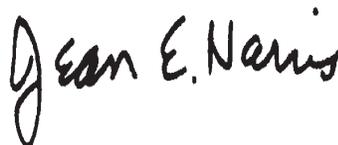
In the *Estate of Forbes v. Commissioner*, the Court concluded, "We are unsatisfied that any of the parties' experts have adequately justified their recommended discount rates – a shortcoming that might be attributable in part to a lack of available empirical data. Given that the parties agree that some valuation discount is appropriate, however, and lacking any firm basis on which we might independently derive one, we accept Lawton's recommended 30% valuation discount as being the most reasonably justified of the opinions presented to us."

In a 2001 case, a family trust held timberland and the decedent held a 26% interest in the trust. The IRS took the position that the only discount allowable in *Estate of Baird v. Commissioner* was the cost to partition. The Court ruled that the taxpayer's 60% claimed discount was appropriate. As a further note, the Fifth Circuit concluded that the IRS' litigation position was unjustified and reversed and remanded the Tax Court's decision not to award the estate its administrative and litigation expenses under Section 7430.

*Estate of Amlie v. Commissioner* is most famous for the Court's opinion on a buy/sell agreement; however, the Estate also held a 56% and a 50% fractional interest in two pieces of agricultural land. While the IRS argues that no discount is appropriate, in litigation the estate recommended discounts between 25% and 35% as appropriate. The Court held that 15% discounts were correct as "the estate has shown entitlement to a fractional interest discount no greater than that which would reduce the values of Parcels 2 and 3 to the amounts reported on the return."

**Conclusion.** The above table and discussion demonstrate that many judicial opinions support discounts greater than the costs of partition in determining fair market value for fractional interests in real estate based upon the facts and circumstances prevailing at the valuation date. Give us a call at 901.685.2120 if we can assist with your fractional interest appraisal.

For more information about fractional interests in real estate, visit our website to see our 1997 article "Valuing Fractional Interests in Real Estate". The Tax Court Memorandums reviewed can be found at <http://ustaxcourt.gov/> under the Opinions Search tab.



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# What's New on Mercer Capital's Web Site

Mercer Capital's website is updated frequently and contains information of interest to attorneys, business owners, bankers, and other professional advisors to business. Please visit often at [www.mercercapital.com](http://www.mercercapital.com).

## ANNOUNCEMENT

### Slides Available from October 15th Webcast :: Buy-Sell Agreements - How to Know Your Agreement Will Work Without Triggering It

Our focus on buy-sell agreements results from over 20 years of experience valuing buy-sell agreements. As such, we have seen well-crafted agreements as well as agreements that were lacking in terms of clarity of information necessary for a business appraiser. This webinar focused on practical information and attracted approximately 400 registrants. You can download the powerpoint deck [HERE](#).

## INDUSTRY FOCUS

### Beverage Industry

Download a copy of the article "Beer Distributors: Is Yesterday's Good Deal Today's Accounting Impairment?" [HERE](#). From the article: "Over the last decade there have been hundreds of transactions in the beer distribution space. The impetus for consolidation has come from the top-down strategy of the breweries and the bottom-up ambition of distributors. Like a great many things before the onset of the financial crisis, the underlying strategies compelling distributor consolidation and deal pricing made better sense then."



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### Medical Device Manufacturers

Download a copy of the article "Valuation of Medical Device Start-Ups" [HERE](#). From the article: "Valuation for start-up enterprises can be a tricky proposition. Because both the subject enterprise and valuation purpose are misfits within the context of typical valuation work, typical valuation practices are generally not applicable for start-up companies. Combined with the unique market dynamics and regulatory environment associated with the medical device industry, medical device start-ups present a unique set of valuation considerations."

## SELECTED LIST OF RECENT & UPCOMING SPEAKING ENGAGEMENTS

November 10, 2009

### "Fair Value in Today's World"

Birmingham FEI Chapter  
Birmingham, Alabama  
Matthew R. Crow, CFA, ASA

November 16, 2009

### "Buy-Sell Agreements"

AICPA's Annual Business Valuation Conference  
San Francisco, California  
Z. Christopher Mercer, ASA, CFA

January 7, 2010

### "Subsequent Events"

Florida Institute of CPAs Valuation, Forensic Accounting,  
and Litigation Conference  
Ft. Lauderdale, Florida  
Z. Christopher Mercer, CFA, ASA

February 1, 2010

### "Important Valuation Issues for Banks in 2010"

Acquire or Be Acquired Conference  
presented by *Bank Director* magazine  
Phoenix, Arizona  
Andrew K. Gibbs, CFA, CPA/ABV

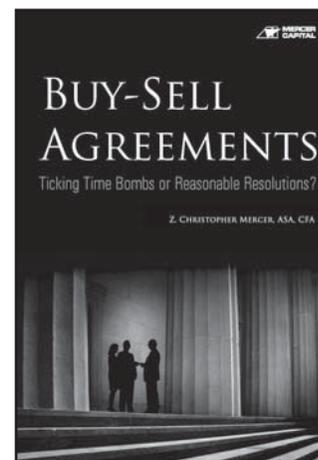
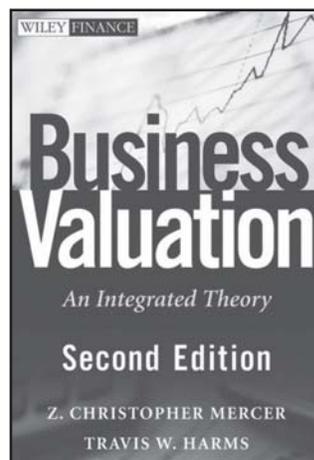
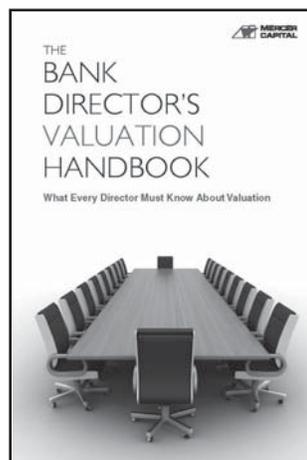
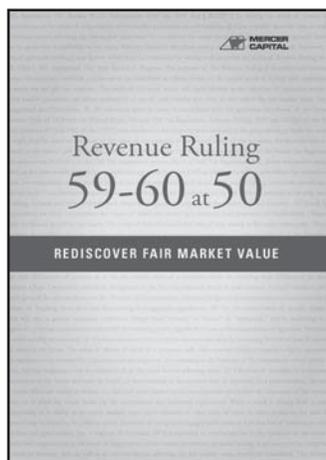
April 10, 2010

### "Buy-Sell Agreements"

ACTEC Regional Meeting  
Knoxville, Tennessee  
Z. Christopher Mercer, CFA, ASA

To see a complete list, visit the [Speaker's Bureau](#) section of our website at [www.mercercapital.com](http://www.mercercapital.com). To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at [priceb@mercercapital.com](mailto:priceb@mercercapital.com), or by calling 901.322.9724.

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## Revenue Ruling 59-60 at 50

*Rediscover  
Fair Market Value*

January 2009

**Sale Price: \$45 (plus s/h)**

Revenue Ruling 59-60 is a compact storehouse of enduring practical wisdom for business appraisers and the users of appraisal reports. To celebrate the 50th anniversary of its publication, we summarize the Ruling and provide a non-technical view of how appraisers attempt to translate its guidance into actual valuation engagements. This 120+ page book is written for attorneys and other users of business appraisal reports.

## The Bank Director's Valuation Handbook

*What Every Director Must  
Know About Valuation*

January 2009

**Sale Price: \$45 (plus s/h)**

Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about important valuation issues. This handbook addresses many of these questions and provides useful information for bank directors and managers when valuation needs emerge.

## Business Valuation, An Integrated Theory

*Second  
Edition*

January 2008

**Reg. Price: \$95 (plus s/h)**

Whether you are a business appraiser, auditor, financial planner, or attorney, *Business Valuation: An Integrated Theory, Second Edition* enables you to understand and correctly apply fundamental valuation concepts. Thoroughly revised and expanded, the Second Edition demystifies modern valuation theory, bringing together various valuation concepts to reveal a comprehensive picture of business valuation.

## Buy-Sell Agreements

*Ticking Time Bombs or  
Reasonable Resolutions?*

January 2007

**Reg. Price: \$79 (plus s/h)**

Does your or your clients' buy-sell agreement say what you think it says? You might be surprised. Written for business owners, attorneys, CPAs, business appraisers, and other professional advisors to business, this book provides a road map for you (or your clients) to develop or improve your buy-sell agreement.

***Coming in December 2009 - Valuation for Impairment Testing, Second Edition***

## A GENTLE PLUG FOR OUR FIRM

**MERCER CAPITAL** is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 25 years of experience, including thousands of assignments, into solutions for the issues of today.

Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

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- » Valuation for Corporate Income Tax Issues
- » Valuation for ESOPs
- » Purchase Price Allocations
- » Goodwill Impairment Testing
- » Valuation of Employee Options
- » Portfolio Valuation Services
- » Valuation of Intangible Assets
- » Fairness Opinions

Mercer Capital's investment banking professionals specialize in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

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The cost of your time and delays in obtaining proposals has just gone down. Use one of the PROPOSAL REQUEST FORMS on our website.

Many of your colleagues have already used our PROPOSAL REQUEST FORMS and are impressed by the decrease in transactional overhead and the increased ease in obtaining actionable proposals for their clients. We are pleased to be doing business with them. Try it yourself! Visit our website and provide us with the pertinent information via this form, and we'll prepare a proposal and deliver it to you via e-mail, fax or USPS. Complete confidentiality is assured.

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Business Valuation » Investment Banking

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