The Valuation of Undivided Interests in Real Property and Factors that Influence the Discount Applied by Business Appraisers

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**IRS position:** business appraisers should not apply discounts to undivided interests in excess of 20%

**Henry & Horne, LLP position:** a higher discount is justified if the tenants-in-common have entered into a co-tenancy agreement

This article will provide valuable insight into IRS Hot Buttons related to the valuation of undivided interests (“co-tenancy interests” or “tenants-in-common interests”) and the actions taxpayers and their professional advisers can take to support higher discounts applied to co-tenancy interests that are being valued for gift or estate tax reporting purposes.

**What is a co-tenancy interest?**

Statutes vest each co-tenant, regardless of the size of his ownership interest, with the equal right to enjoy the entire property and share, on a pro rata basis, revenues and obligations associated with the property. For instance, if a co-tenant holds a 25% undivided interest in an office building, he is theoretically entitled to 25% of the building’s cash flow and obligated to pay 25% of the building’s expenses such as utilities, property taxes, tenant improvements, debt service and professional fees.

**What is a Partition?**

Partition is a term used in the law of real property to describe an act, by court order or otherwise, to divide real property into separate portions representing the proportionate ownership interests of the co-tenants. Under common law, any tenant who owns an undivided concurrent interest in a property can seek such a division.

**Why would the owner of an undivided interest want to partition a property?**

The primary reasons that would cause a tenant-in-common to file a petition for partition are attributable to the co-tenant’s desire to derive funds related to the sale of the property or to extricate itself from a contentious relationship with the other property owners.
What is voluntary and involuntary partition?

Voluntary partition occurs when the co-tenants divide the property themselves, usually by exchanging individual deeds. As a result, each co-owner owns an agreed upon portion of the property and ceases to hold an undivided interest in the whole. The parties may also decide to sell the property and ratably divide the proceeds among themselves.

When co-owners cannot agree to a voluntary partition, a lawsuit to compel partition can be filed to sever property interests. Unless there are exceptional circumstances, a tenant-in-common has the absolute right to seek a compulsory partition. Partition must be made even if every other owner objects to it. The motives of the party seeking partition are irrelevant, and the court that hears the lawsuit has no discretion to deny partition. Its main function is to determine the method of effectuating the partition. Commonly, the court will order the property sold and the net proceeds proportionately divided instead of ordering a physical partition of the property.

The IRS believes discounts between 15% and 20% should be applied to undivided interests in real property

The IRS has taken the position that the business appraiser should only utilize the cost-of-partition method when valuing an undivided interest in real property rather than relying on the asset, sales comparison and/or income approaches to value. The cost-to-partition method typically indicates a blended lack of control and lack of marketability discount between 15% and 20%.

What is the cost-of-partition approach?

The cost-of-partition approach to value is predicated on the premise that the market value of a co-tenancy interest is equivalent to the pro rata equity in the property held by the tenant in common less anticipated expenses associated with the partitionment of the real estate.

The partition cost analysis is essentially comprised of two components: the cost of the real estate partition lawsuit and the expenditures associated with the delays and uncertainty related to the partitioning process.

Below are some of the expenses which should be contemplated by the business valuater based on facts and circumstances.

- Survey of the property.
- Appraisal of the property.
- Engineering and structural costs required to physically divide the property.
• Construction of improvements during the holding period.

• Cost to replace shared property access, utilities, infrastructure, etc.

• Legal and other professional fees.

• Prepayment penalties related to covenants in a loan agreement.

• Rental income and other sources of cash expected between the valuation date and the presumed date on which the property is sold and proceeds distributed to the co-tenants.

• Property taxes, insurance, utilities, maintenance, repairs, management fees, debt service, etc. and other expenditures anticipated during partition process.

The appraiser should also consider the potential for appreciation or depreciation of the market value of the property during the course of the partition.

Without engaging a surveyor, engineer, attorney, and other professional advisers or interviewing the owner of the other undivided interests in the property, it is extremely difficult for the valuator to enumerate or quantify the costs related to the partitioning or the length of time it would take to complete the partitionment.

With that said, it is our opinion based on independent research that (1) annual expenses would be about 1% per annum of the appraised value of the property; (2) it would likely take two years from the date of valuation to compel and consummate the sale of property; (3) the property's market value would increase at a rate of about 3% per annum during the 24 months; and (4) closing costs and commissions would approximate 5% of the transaction price of the property.

**What is a co-tenancy agreement?**

Commonly called "co-ownership" or "co-tenancy" agreements, these documents address relevant issues which might otherwise plague such a relationship, since there is no forum for their resolution other than a partition action in a state district court. Below are terms and conditions generally incorporated in an agreement.

*How is ownership divided between the parties?*

Ownership, which is documented in a deed of trust, is usually consistent with each co-tenant's monetary contribution at the time the property is purchased.
**How will expenditures such as maintenance and repairs be divided amongst the parties?**

Often the co-tenancy agreement requires the tenants-in-common to open a checking account funded proportionally to pay expenses, or they may decide to pay each expenditure ratably when it is due and payable. If an expense is not paid by a co-tenant, the agreement can address contingent actions available to the paying parties.

**How will the property be used by each party?**

If, for example, a residence is shared by two co-owners, then the agreement would presumably entitle them to use it for a portion of the year that is commensurate with ownership. In addition, rental income derived from the leasing of a vacation home to third parties is customarily distributed in accordance with the co-tenant’s ownership percentages.

**Who has the authority to encumber the property?**

Co-tenancy agreements recognize that mortgages encumbering real property are typically joint and several obligations of the parties. Furthermore, many agreements do not permit the tenants-in-common to pledge their undivided interests as collateral for a personal loan.

**How will a decision to sell the property be made by the parties?**

Normally these agreements provide for a “right of first refusal” so that when one party wants out, the other is given the opportunity to buy that interest. The sales price is normally a function of the appraised value of the property and liabilities associated with the property. The proceeds of a sale are divided in accordance with each tenant-in-common’s ownership percentage.

**Can a co-tenancy agreement prohibit the partitioning of the property?**

The preclusion of the right to partition the property may be the most important governing provision in a co-tenancy agreement. As previously discussed, the process can be costly, arduous, contentious and protracted. Therefore, prohibiting each tenant-in-common from initiating said action can be a great benefit to all parties.

**Discounts between 25% and 35% can be applied to a tenancy-in-common interest when the actions of the co-tenants are governed by a co-tenancy agreement.**

It is our experience that a blended discount in the range of 25% to 35% can be applied to a co-tenancy interest if the parties are bound by a co-tenancy agreement that includes a non-partition clause. Keep in mind that tax courts will sometimes not enforce an agreement that restricts the right to partition for an
indefinite period of time. Therefore, we recommend that a notice be issued to the tenants-in-common each year that requests their written consent not to exercise a partition action during the next twelve months.

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