VALUATION OBSERVATIONS

Some practical observations from a practicing business appraiser.

VLC

Valuation & Litigation Consulting, LLC
600 E. Granger Road, Second Floor
Cleveland, Ohio 44131

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CO-TENANCIES AND THE FRACTIONAL INTEREST DISCOUNT

Common tenancy is a less formal means of implementing fractional interest in real estate. It represents a third organizational form that is amenable to the same valuation process that applies to corporate holding companies and partnerships. However, even though common tenancy is a simple form of ownership, its valuation is not quite as straightforward as the holding companies and partnerships. The complexity increases because there are no formal agreements in place regarding ownership, management and financing, among other things. Additionally, statutory law shall apply to the cotenant's rights and duties due to the lack of formal agreement between the cotenants. As such, it is important to fully understand the laws of the state in which the property sits.

Although some rights and provisions may vary by state, there are certain definitions that are particular to valuing common tenancy interests.

Tenancy in Common
Tenancy in common is an estate held by two or more persons, each of whom has an undivided interest. No one interest controls the property, and a similar interest of any size can block important decisions concerning the property.

Right of possession
Cotenants enjoy an equal right of possession. Each may occupy the entire property but may not exclude the others. When one cotenant is in possession of the property, he or she is not liable to the other cotenants for its rental value or the value of his labor. However, he or she must give an accounting to the cotenant(s) for a share of any rents and profits received from third persons and for profits derived from the use of the land that may involve removing a natural resource such as oil or minerals.

Repairs and capital improvements
A cotenant generally has a right of contribution if he or she pays taxes or other liens or for necessary repairs. Such expenses may be deducted from income. No corresponding right of contribution regarding capital improvements exists unless the other cotenants have agreed to the improvements.

Leases
A cotenant cannot execute a lease for the whole property or a specific portion that will bind the other cotenants and confer exclusive possession to the lessee, but a cotenant may execute a lease for its undivided portion. A lease that gives a third-party tenant the right to occupy the entire property would have to be signed by all cotenants.

Agreements
The cotenants may make an agreement among themselves as to the right of possession, payment of rental value in lieu of possession, or virtually any other terms they deem appropriate.

Transfer of interest
A common tenancy interest may be transferred voluntarily or by the operation of law, without any restriction and without notice to the other cotenants.

Partition
A cotenant has the absolute right to sue for partition; that is, to ask the court to divide the property between other cotenants or to require a sale if such a division is not possible. However, a cotenant may restrict or give up this right by agreement. If the property cannot be partitioned in kind (physically divided), then the court can order sale of the property and division of the proceeds.

Different methods of valuation consider the different elements of value in arriving at an overall conclusion. An investor is concerned with the future cash flows and discount rates as well as control of the property, holding time, and expenses associated with the property.

The value of the interest must be determined with a view toward the intrinsic value of the Property, the value of its income flow, and the fair market value of the fractional interests in the marketplace. The IRS Manual provides that the appropriate discount for a fractional interest in real property is based on several factors. In particular, the IRS Manual states that, in addition to the costs of dividing the land (i.e. partition), the following factors will also influence the amount of the discount:

a) The size of the fractional interest: smaller interest = larger discount.
b) The number of owners: more owners = larger discount.
c) The size of the tract (i.e. practicality of partition): smaller tract = larger discount.
d) The use of the land: farmland = larger discount.
e) Availability of financing for undivided interests: tighter financing=greater discount.

Like the Service, the Courts have consistently recognized that the sum of all fractional interests in a property is less than the whole and have upheld the use of fractional interest discounts in valuing undivided interests. Oftentimes, the discount is derived by consideration of (1) comparable sales of fractional interests and (2) the cost to partition the property. A discount is appropriate because of problems of control, lack of marketability, and costs of partition or forced sale relating to a fractional undivided interest; and is supported by numerous precedents. Additionally, there are numerous cases related specifically to property not capable of partition. When relying on case law, it is important to consider only cases where the property is similarly situated.

If you would like additional information, or have a question, please do not hesitate to call.

Terri A. Lastovka, CPA, JD, ASA
Ph: 216-661-6626
Fax: 888-236-4907
lastovka@valueohio.com

Member of:

American Society of Appraisers
ASA
The International Society of Professional Valuers

Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.