

CALIFORNIA SOCIETY OF CPA'S Marina Del Rey, CA

Fractional Interest Discounts
October 19, 2011



IRS LARGE BUSINESS AND
INTERNATIONAL DIVISION

Welcome

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

Presented by:

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



METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

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

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

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

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

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

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

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

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

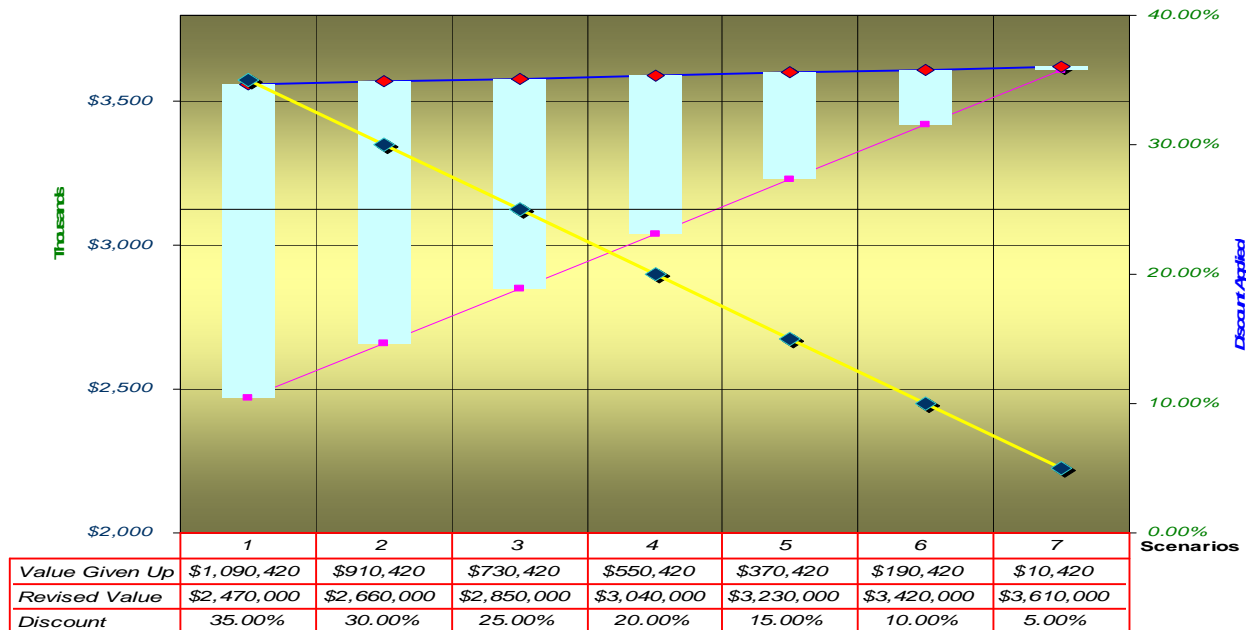
WAIVER OF RIGHT TO PARTITION

- 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

MINORITY PREMIUM

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



METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

MINORITY PREMIUM

LAST COLUMN IN SPREADSHEET -

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



METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

MINORITY PREMIUM

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



METHODOLOGIES FOR VALUING FRACTIONAL INTERESTS

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
Actual Transactions				
Fractional to Fractional	28.00%	\$2,736,000	4	\$109,440
Whole to Fractional	0.00%	\$3,800,000	5	\$190,000
Cost-To-Partition				
Present Holder	28.00%	\$2,736,000	4	\$109,440
Hypothetical Buyer	31.00%	\$2,622,000	2	\$52,440
Minority Premium	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
Actual Transactions				
Fractional to Fractional	28.00%	\$576,000	25	\$144,000
Whole to Fractional	0.00%	\$800,000	25	\$200,000
Cost-To-Partition				
Present Holder	28.00%	\$576,000	30	\$172,800
Hypothetical Buyer	31.00%	\$552,000	15	\$82,800
Minority Premium	3.00%	\$776,000	5	\$38,800

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

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

CONTACT INFORMATION

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Questions