



Valuation Discounts with Undivided Interests in Real Property¹

By: Brian Layman



We all know that a fractional interest in any asset is worth less than its prorata portion of the appraised value of the whole asset. The reason is simple. If A and B own Blueacre as equal co-tenants and A desires to sell his undivided interest, there is a limited market for his undivided interest. Who wants to buy an asset and be forced into partnership with B? Therefore, there is an inherent discount associated with A's undivided fractional interest because it is less marketable than ownership of the whole.

The issue is not whether a discount is appropriate, but what is the appropriate discount. This is particularly important in today's environment because of the Internal Revenue Service's increased hostility towards discounts associated with entities (e.g., family limited partnerships or limited liability companies). Entities are also relatively expensive to set up and maintain. Very few clients understand the importance of dotting all of the i's and crossing all of the t's. Following these formalities is absolutely critical to have any chance of success with the Service. Tenancy in common interests are much simpler.

The Service has privately ruled that the marketability discount associated with an undivided interest in real property is limited to the cost to partition (approximately 5%).² However, in *Estate of Baird*, the Fifth Circuit awarded attorney fees to the taxpayer because it held that the Service's position was unsupported.³ The courts have consistently held that the appropriate discount is based upon all of the facts and circumstances involved in a particular case and that the discount is not limited to the cost to partition.⁴ It is truly a valuation issue. The reported discounts range from 10% - 60%, with 15% being the most frequent. While the Service may choose not to accept reality publicly, it has at least recognized it internally. The IRS Training Manual for Appeals Officers Coursebook 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:

- The size of the fractional interest: smaller interest = larger discount.
- The number of owners: more owners = larger discount.
- The size of the tract (i.e., practicality of partition): smaller tract = larger discount.
- The use of the land: farmland = larger discount.
- Availability of financing for undivided interests: tighter financing = greater discount.⁵

In order to support the appraised value of an undivided interest, you may need two separate appraisals, one of the entire interest and one of the undivided interest. The expert who appraises the entire interest may or may not be qualified to appraise the undivided interest. The problem is that there are very few comparables for an undivided interest, particularly on a local level. Therefore, it may be necessary to engage a second expert to determine the appropriate discount for the undivided interest.

The discounts associated with fractional interests present opportunities. Many spouses hold valuable real estate as joint tenants with rights of survivorship. You could advise them to execute and record a new deed that terminates the joint tenancy and creates a tenancy in common. By doing so, you could "create" a discount for lack of marketability which could substantially improve their tax position. You would counsel them on the need to avoid probate, most likely by transferring the undivided interests to separate revocable trusts.

While significant discounts are available, the key to defending the discount is to firmly establish the credibility of the expert's analysis and conclusion. As with any planning technique, understanding the risks and benefits are critical.⁶ However, most clients will appreciate the simplicity and the tax benefits associated with this technique.

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¹ This article is based upon a portion of the author's article entitled *Tried and True, but Often Overlooked Tax Planning Techniques*, 19 OHIO PROBATE LAW JOURNAL 45 (Sept/Oct 2008).

² TAM 9336002 (May 28, 1993) and TAM 199943003 (Nov. 1, 1999).

³ Baird v. Comm., 416 F.3d 442 (5th Cir., 2005) 60%.

⁴ Campanari v. Comm., 5 T.C. 488 (1945) 12.5%; Herter v. Comm., T.C. Memo 1954-298 (1954) 15%; Whitehead v. Comm., T.C. Memo 1974-53 (1974) 14.25%; Propstra v. Comm., 680 F.2d 1248 (9th Cir. 1982) 15%; Sels v. Comm., T.C. Memo 1986-501 (1986) 60% ; Youle v. Comm., T.C. Memo 1989-138 (1989) 12.5%; Wildman v. Comm., T.C. Memo 1989-667 (1989) 15%; Mooneyham v. Comm., T.C. Memo 1991-178 (1991) 15%; Baggett v. Comm., T.C. Memo 1991-362 (1991) 35%; Feuchter v. Comm., T.C. Memo 1992-97 (1992) 15%; Pillsbury v. Comm., T.C. Memo 1992-425 (1992) 15%; LeFrak v. Comm., T.C. Memo 1993-526 (1993) 30%; Cervin v. Comm., T.C. Memo 1994-550 (1994) 20%; Barge v. Comm., T.C. Memo 1997-188 (1997) 26%; Williams v. Comm., T.C. Memo 1998-59 (1998) 44% ; Brocade v. Comm., T.C. Memo 1999-424 (1999) 24%; Busch v. Comm., T.C. Memo 2000-3 (2000) 10%; Stevens v. Comm., T.C. Memo 2000-53 (2000) 25%; Forbes v. Comm., T.C. Memo 2001-72 (2001) 30%; Amlie v. Comm., T.C. Memo 2006-76 (2006) 15%.

⁵ IRS Training Manual for Appeals Officers Coursebook (CCH), Chapter 4, Pages 26 – 27.

⁶ For a more detailed analysis of the issues that should be addressed when planning with undivided interests in real property, see Howard M. Zaritzky's article outline entitled *Effective Tax Saving Techniques for Real Clients (Don't Slide Down the Cutting Edge)* presented at the ABA's Real Property Probate & Trust Law Spring 2007 Symposia