Valuation of Undivided Interests—The Elephant in the Room: How Much Emphasis on Partition Analysis?

by Donald Sonneman

Abstract

When valuing undivided (fractional) interests in real estate, valuation experts tend to rely more heavily on market evidence of control and marketability discounts. In contrast, the IRS is more likely to place either exclusive or heavy emphasis on partition analysis, reasoning that when partition analysis appears to provide the highest available value to a seller, the hypothetical seller will choose that option. However, that reasoning ignores the sizeable financial risks associated with the partition process, which make it an infrequently chosen investor option. This article discusses the tension between the two approaches.

The valuation of undivided (fractional) interests in real estate has been a source of tension between valuation practitioners and the IRS for many years. Valuation experts tend to rely more heavily on market evidence of control and marketability discounts from sources like undivided interest transactions, other real estate partial interest transaction databases, and required rates of return for undivided interests or other partial interests.

In contrast, the IRS is more likely to place either exclusive or heavy emphasis on partition analysis, reasoning that when partition analysis appears to provide the highest available value to a seller, the hypothetical seller will choose that option. However, this reasoning ignores the sizeable financial risks associated with the partition process, which make it an infrequently chosen investor option. Or perhaps the IRS assumes that the seller has the option of gaining cooperation of other owners in the sale of the entire property, eliminating any discounts from pro-rata value. These reasons are not consistent with marketplace realities or the definition of fair market value. But the tension between the IRS and many practitioners hides the larger issue: Appraisal literature appears to provide no consistent guidance on the role of, and emphasis on, partition analysis versus other methods of valuation.

This article examines two issues:

1. Proposed reasons for placing far less emphasis on partition analysis (compared to benchmark studies or discounted cash flow analysis using comparable rates of return)
2. Questions to consider in determining how much emphasis to place on partition analysis (these are intended to give the valuation practitioner a more reasonable framework for considering the role and use of partition analysis)

Reprinted from the *The Value Examiner*, July/August 2020 issue, 25–32, with permission from the National Association of Certified Valuators and Analysts® (NACVA®). To learn more, please visit http://www.NACVA.com/ValueExaminer.

Background Related to Real Estate Interests

Undivided interests are also known as fractional interests or tenancy-in-common interests. The valuation of undivided interests in real estate typically includes consideration and analysis of several categories of market evidence. The analysis results in estimating a discount from net asset value to address relative lack of control and/or marketability.

The valuation practitioner is left in the dark regarding when and how strongly to consider partition analysis and what factors to consider to support that decision.

Market evidence typically considered reflects investor behavior. Examples include benchmark studies of sales transactions involving undivided interests in real estate, transactions involving sales of public partnerships and REITS on the secondary market (through Partnership Profiles), and other indicators of marketability discounts, such as restricted stock studies. The studies related to real estate interests are listed in Exhibits 1–3. Also, where typical rates of return for similar fractional or partial interests are available, they are considered. Partnership Profiles includes such data in its rate-of-return study.

Although these sources provide market-based evidence of investor behavior, they each have flaws and limitations that affect their reliability. The benchmark studies of sale transactions are composed of a relatively small number of transactions for which little or no background information is available. And these transactions include a variety of real estate types and percentage interests. So, good comparables for the subject interest being appraised are often rare. Similar problems occur when seeking highly similar or comparable investments for rates of return.

Partition analysis is also a potential consideration, provided the right to partition is present. That right is available by law unless an operating agreement signed by the interest holders prohibits exercising the partition right or an inheritance stipulation prevents property division. The focus of this article is undivided interests that have the partition right, which gives an undivided interest holder the ability to petition a local court to either divide the property, divide the income, or sell the property and divide the proceeds. An analysis based on partition action usually assumes a court process ending with a property sale (although other scenarios are possible). A discounted cash flow analysis reflects the present value of the cash flows resulting from the partition action as compared to net asset value. As part of that analysis, the valuation practitioner estimates the time frames for the partition action and property sale, and uses that analysis to estimate control and marketability discounts.

The author has reviewed several articles, published over the last 25 years, that discuss methods for valuing undivided interests. These articles typically lack any guidance on the following two issues:

1. How frequently does partition actually take place versus other means of exiting an undivided interest investment?
2. What weight or emphasis should partition analysis receive relative to other valuation methods?

The author has consulted some prominent valuation practitioners to confirm that such information and guidance is not available. Generally, the literature is either silent on these issues or leaves it to the valuation practitioner's judgment. (A list of some of the more informative publications appears at the end of this article.)

The valuation practitioner is left in the dark regarding when and how strongly to consider partition analysis and what factors to consider to support that decision. Yet the debate continues between valuation practitioners (and sometimes with the IRS) regarding how important a role, if any, partition analysis should play in a valuation of an undivided interest in real estate.

Reasons Partition Analysis Should Receive Far Less Emphasis than Other Methods

In any valuation, the practitioner's responsibility is to explain and defend the weight or emphasis given to each valuation approach. This is required by USPAP Standard 1-6 for real estate interest appraisals, as well as most business valu-

Exhibit 1 Market Evidence Summary

Several Decades of Benchmark Market Evidence from Sales Transactions Studies That Directly Addressed Transactions of Undivided Interests

Organization Performing Study	No. of Transactions	Type of Interest Sold	Type of Transactions	Approximate Discount from Pro-Rata Value	Period of Transactions	Locations
Stout Proprietary Database (formerly FMV Database with 15 transactions added)	80	Undivided	• Commercial property • Residential property • Land	Roughly similar discounts to FMV study below with 20% +/– more transactions	1972–2004	Six States
FMV Database	65	Undivided	• Commercial property • Residential property • Land	Median all: 36.7% Median income producing: 33% Median non-income producing: 41%	1972–1996	Six States
Eckhoff Accountancy Corporation Data Collection	61	Undivided	• Undeveloped land • Agricultural land • Commercial property • Residential rentals	Average 37%, median 36%; highest discounts for undeveloped land	2003 and Earlier	Seven States
Willamette Management Associates study	9	Undivided	Not specified	Average 15%, median 16%, but based on assessed value estimated 10% below market. Implied discount to pro-rata value: average 25%, median 26%	1985–1986	Oregon
Harris-McCormick-Davis study (Presented in December 1983 issue of *ASA Valuation*)	21	Undivided	Agricultural land	Average 32.05%	1983	Southeast Region
Peterson Hafter Klafton private study	13	Undivided	Not known	Average 50% (During Local Recession)	1980–1986	Tucson, AZ
Patchin study	24 (The study also examined 30 partnership interests)	Undivided	Agricultural land	Group 1: average 56%, median 50%	1972–1981	Texas
				Group 2: average 32.1%, median not available	Not available	Various

Note: the following studies were not included because of insufficient or unrelated information:

- Healy study (1988 study appears to cover only interests that are not undivided interests)
- Peterson-Hafter-Klafton study (private study—unable to determine whether undivided interest or other)

Exhibit 2 Secondary Market Evidence—Control and Marketability Discounts

For Other Noncontrolling Interests in Real Estate
Secondary Market Sales of Public Limited Partnership Interests and REIT Interests
(Partnership Profiles)

Lack of control and marketability discounts are for different ownership structures with different operating restrictions.
However, important trends also apply to undivided interests by analogy and similar investment logic:

- Higher discounts for interests in entities with moderate to high debt vs. low or no debt
- Higher discounts for interests in entities with no distributions vs. with distributions
- Higher discounts for interests in entities with undeveloped land vs. investments with distributions
- Lower discounts for interests in entities with announced liquidation plans vs. entities without liquidation plans

Number of years of market data: partnership data (1994–present), inclusion of REIT data (approx. 2009–2020)

Exhibit 3 Secondary Market Evidence—Rate of Return Study

For Other Noncontrolling Interests in Real Estate
Secondary Market Sales of Public Limited Partnership Interests and REIT Interests
(Partnership Profiles)

Rates of return are for different ownership structures with different operating restrictions.
However, important trends also apply to the income approach for undivided interests by analogy and similar investment logic:

- Higher discounts for interests in entities with moderate to high debt vs. low or no debt
- Higher discounts for interests in entities with no distributions vs. with distributions

Also, the rate of return can be adjusted for other differences in risk and differences in other characteristics.

Number of years of market data: partnership data (1994–present); inclusion of REIT data (approx. 2009–2020)

Note: The three categories of studies listed above are not intended to be an all-inclusive list of relevant information for valuators.

Some valuators may also access proprietary information reflecting REIT discount and performance data.

ation standards. In many cases, this reconciliation process is not well explained with regard to partition analysis. This article is intended to put that process on a firmer footing. In a sound valuation, the emphasis on each valuation approach should reflect the way a typical investor would apply the same approaches.

Following are reasons a partition analysis should typically receive far less than primary emphasis.

Reason 1: A partition action is a last resort, not a first resort. Just because a partition right is available, that does not mean it is frequently used, or prominently considered in estimating value. A partition action is consistently characterized as a last resort among exit strategies by attorneys and valuation experts. In other words, it is the exception rather than the rule.

Eric Nath, a well-known business valuation practitioner, addresses partition analysis this way: "Obviously, a fractional owner in real estate usually has the right to partition unless this right is contractually limited. When sellers of fractional interests go to market, do they use the partition argument as a basis for demanding a high price? I don't think so. In fact, even at a deeply discounted price it has to be extremely rare that anyone purchases a fractional interest in real estate with the express intention of initiating a partition. The ability to partition is a last resort in case things don't work out." Nath's view is echoed by many attorneys and valuation experts experienced with partition actions.

"Things not working out" may take many forms: Interest holders may disagree with each other on when to sell and when to hold an investment, when to finance, when additional capital investment is needed, whether operating income is adequate, whether management practices need to change, or simply the availability of alternative investments that offer a better return. In an undivided interest structure, stalemates can occur if the decision-making process is not addressed in an operating agreement.

When a buyer purchases an undivided interest in real estate, the purchase is based on a planned or anticipated holding period over which the owner expects income distributions, appreciation, or both. A partition action is an unexpected departure from the anticipated cash flows and holding period. Therefore, it is not typically a significant consideration when an investor assesses the value of the investment. Why would an investor plan to disrupt the holding period and make income and appreciation less predictable? A partition action is unexpected and unplanned, and an undesirable last resort.

Consider a reasonableness test. How reasonable would it be if partition actions were not considered a last resort? How congested and overburdened would the local civil courts be if 70–80 percent of undivided interest holders chose to use the court partition process as their primary exit strategy? How much more unpredictable would investment returns be if investors relied primarily on the courts for interim management and sale of the underlying property?

Conclusion: A typical investor views partition as a last resort, not a first resort.

Reason 2: Most investors loath the idea of using the court system as an exit strategy. Few investors use the courts to facilitate their exit from an investment, with good reason. Investors do not control the amount of time needed to achieve partition, and there is uncertainty regarding the sales price, terms, and court costs. When investors want to liquidate their holdings, they prefer to use trusted avenues and trusted parties—such as accountants, attorneys, or brokers—to sell their interests. Court systems are almost universally mistrusted by investors.

Conclusion: Most investors will not opt to use their partition right because of mistrust of the court system.

Reason 3: A low discount reflected in a partition analysis is often fool's gold and a rational investor knows it. This is one area where we focus on the perspective of a hypothetical willing seller. The straw man question is often posed as follows: Why would an owner sell his or her undivided interest at a discount that would result in a lower payment than what could be achieved through partition? Doesn't the discount rate used in the partition analysis reflect the risk and uncertainty of the partition process? Often, a partition analysis relies on growing the value of the asset by a moderate rate, say 2.5–3 percent. This growth takes place annually over an estimated partition action period as short as two or three years. And the discount rate applied to the cash flows is increased by a modest increment to reflect the uncertainties of this court-driven process.

But rational and well-informed investors know that, based on past history, recession is a risk.

The National Bureau of Economic Research analyzed all cycles of economic contraction and expansion from 1854 through 2009. Its data indicated that recession/contraction conditions occurred an average of roughly 31 percent of the time, based on 17.5 months of recession out of an average period of 56.2 months to cover expansion followed by recession. And during an unusually long expansion, recession expectations tend to grow beyond that average. An investor could readily assume that 30–50 percent of the time a recession will occur during the period of a partition action. During a recession, value generally decreases and discount rates applicable to cash flows increase, and marketing times can increase. An attractive 15 percent discount for lack of control and marketability can rapidly grow to 25–30 percent or more, and an additional year or two of legal action and delay can easily balloon the discount to 40 percent or more.

For brevity, supporting analysis is not included in this article. Interested readers may contact the author at valexcel@cox.net to receive an illustrative example with four exhibits showing how control and marketability discounts increase substantially if a recession is assumed rather than moderate growth. Fools rush in, but the rational investors (required by the definition of fair market value) do not.

Conclusion: Most investors will forgo a partition action because of recession risk during the partition process. A substantial probability (say 30–50 percent) of a much higher discount than estimated is a major deterrent to use of a partition action.

Reason 4: Alternative exit strategies are much more prevalent than partition actions. This is a second area where we focus on the willing seller's perspective. Investors initially invest in real estate investments for two core reasons: (1) a reliable and reasonable annual return or distribution and (2) an opportunity for significant appreciation in the property's value over time. As long as these two elements are reasonable and likely, they tend to stay invested. Partition actions are only considered under extraordinary circumstances. Most undivided interest owners hold their interests for long periods, ranging from years to multiple decades. And when they opt to liquidate their interests, they usually sell either to the co-owners or outside parties, or transfer their interests to family members, rather than use a court proceeding. A rational investor normally envisions a holding period of several years followed by a normal sale process or an intrafamily transfer.

Conclusion: Most investors will not opt to use their partition right because they plan on other exit strategies.

A rational investor normally envisions a holding period of several years followed by a normal sale process or an intrafamily transfer.

Reason 5: A partition action is most likely when cooperation among owners is minimal. Typically, a partition action is not considered unless cooperation among owners is thought to be insufficient for the investment to continue to perform adequately. Conditions that may trigger a partition action include decision-making stalemates, inadequate management, inadequate investment performance, conflicting liquidity goals, or some combination thereof.

Conclusion: The best support for imminent partition action is clear evidence of lack of cooperation among the interest holders. In the absence of that evidence, partition action is far less likely.

Reason 6: If liquidity is needed, most partition actions take more time to complete than a normal sale to another party. Partition actions typically require more than a year and most require a two- to three-year period before liquidity is achieved. If liquidity is needed more rapidly by one interest holder, a sale of the interest to an outside party can normally be achieved within six months to one year. Additional delay in selling (achieving liquidity) through partition could readily result in a deeper discount in pro-rata value than a sale of the undivided interest on the open market. Such a delay often occurs with a sale in connection with partition, regardless of whether the partition takes place during a recession or more normal market conditions.

Conclusion: If liquidity is desired within one year, a partition action is less desirable and far less likely to be pursued.

Reason 7: Investors view partition potential as just one factor in estimating value of the interest. When a willing buyer and a willing seller agree to a price, they each value the interest based on multiple factors. The susceptibility of the property to partition is only one factor of many. Others include distribution history, distribution size relative to net asset value, underlying property characteristics, number of co-owners, interest size, and market conditions.

Conclusion: Partition analysis is not the sole factor in estimating value. It is merely one factor among many.

Reason 8: Partition analysis should not be used to obscure or de-emphasize market evidence for control and marketability discounts. In a valuation, a core responsibility of the appraiser is to reflect and model the behavior of market participants. If partition analysis is given either sole or primary emphasis, the result is de-emphasis of various forms of market evidence for control and marketability discounts. Any knowledgeable appraiser of undivided interests would admit that such market evidence is extremely limited and may have limited relevance to the specific interest being appraised. But these limitations do not justify ignoring available market data. This evidence should be considered in a balanced manner, regardless of whether it benefits the client or the IRS.

Conclusion: Market evidence for control and marketability discounts should not be ignored.

Reason 9: Use of partition analysis may blur the definition of fair market value. An important component of the definition of fair market value is the concept of a willing buyer and a willing seller, acting at arm's length and not under duress. Typically, the precursor to a partition action is lack of cooperation among owners. This may cause the owner of the subject interest to feel trapped and, therefore, opt for a partition action as a way out. This type of behavior may signify a seller who is under duress and perhaps selling unwillingly or prematurely.

Conclusion: Evidence of duress may conflict with the fair market value standard. In such cases, excluding the partition method from consideration may be appropriate. Arguably, it would be reasonable to place minimal emphasis on partition analysis absent some specific history of lack of cooperation among owners.

Reason 10: The role of the willing seller should not be considered in isolation. A willing buyer is also required to comply with the fair market value definition. In valuations for the IRS, fair market value is generally defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having knowledge of the relevant facts. This definition does not seem to contemplate a court-defined sale process, but instead implies a process that includes both a buyer and a seller who are free to arrive at a mutually acceptable sale price without interference from or delays by the court system.

Conclusion: Use of the partition method may violate the fair market value standard. Therefore, excluding the partition method from consideration may be appropriate, particularly if a buyer does not normally consider it a factor in setting sale price.

Questions to Ask in Determining How Much Emphasis to Place on Partition Analysis

To explain and defend the weight or emphasis given to partition analysis, a valuator should consider the 10 reasons presented above and answer the following questions. Each question assumes that the emphasis placed on any valuation approach should be based on rational investor behavior in the local market.

The answers to many of these questions may be obtained, when feasible, through anecdotal interviews or surveys of local brokers, accountants, and attorneys that deal with clients who hold such interests, as well as by contacting investors who hold such interests.

Question 1: What percentage of undivided interest holders exit their investments through partition action in the local market? Hard data on such actions may be difficult to find, in which case the anecdotal interview or survey process could be helpful.

Question 2: Does the frequency of use of partition actions vary with the underlying property type? For example, are partition actions more common with single-family residences than other types of properties? If so, why?

Question 3: If partition actions are infrequently used as an exit strategy—say, 10 percent or less of the time—should that be considered in the weighting given to partition analysis? The assumption is that we mirror investor behavior in assigning weight or emphasis to valuation approaches and methods.

Question 4: Is some level of documented dispute or disagreement necessary to place more weight or emphasis on partition? In an assumed partition action, a documented dispute or disagreement lends greater support for that assumed partition action than an undocumented dispute or the generalized potential for dispute, especially if a valuation is later subject to court review. First, investors generally go through a period of becoming acquainted with their fellow interest holders and the investment's operations. After that period, they may become dissatisfied with management and/or investment performance and may feel that they have no practical influence over their investment. The valuator should determine whether such dissatisfaction has been documented. The approach is similar to the potential liquidation of a partnership, which generally is not considered in determining control and marketability discounts unless there have been documented plans or votes in that direction. Similarly, partition should only be considered a significant option if there is evidence to support such an action.

Question 5: Do owners of undivided interests in the local market view partition as a last resort or as a primary consideration in estimating value?

Question 6: What factors do most buyers in the local market focus on when estimating the price for an undivided interest? Again, this can be tested by anecdotal interviews with brokers, accountants, and attorneys that deal with clients who hold such interests. Will the relevant factors focus on estimated cash flow, distribution history, number of owners, management quality, quality of the investment, and fractional interest sale restrictions? Or will partition considerations be prioritized?

Question 7: Do rational buyers in the local market simply avoid undivided interest investments when there is a history of disputes and mismanagement? Or do they seek those undivided interest investments where partition action is likely?

Question 8: Do local investors in undivided interests consider an array of valuation approaches (of which partition analysis is just one) or do they place substantial emphasis on partition analysis? This question should be posed to accountants and attorneys who may have familiarity with undivided interest transactions.

Question 9: Can the valuator identify any nongovernmental valuation or investment literature that recommends partition analysis to the exclusion of all other methods of valuing undivided interests?

Question 10: Can the valuator identify any nongovernmental valuation or investment literature that recommends placing primary emphasis on partition analysis in valuing undivided interests?

The questions listed above examine investor behavior. The answers can help a valuator support the weight or emphasis given to partition analysis in valuing an undivided interest in real estate.

Conclusion

This article examined two issues in valuing undivided interests in real estate: (1) primary reasons for placing far less emphasis on partition analysis than other methods and (2) questions to consider in determining how much emphasis to place on partition analysis. The application of these two frameworks may well support assigning little weight to partition analysis in most cases. Also, incorporating recessionary assumptions into partition analysis may generate lack of control and marketability discounts that are much more consistent with other market evidence of these discounts. Application of these frameworks should put the reconciliation process on a firmer and more defensible footing.

About the Author

Donald Sonneman holds an ASA designation in real property appraisal. His practice, AblePlus Valuations, includes business valuation, real estate appraisal, and partial interest valuation. His publications cover business valuation, real estate appraisal, tax assessment, real estate investment, and contributions to an Appraisal Institute book on appraisal of industrial properties. Sonneman's expertise includes valuing fractional and other partial interests for business and real estate interests for more than twenty years. A further focus is online course development for commercial real estate appraisers. His training provides understanding of partial interest valuation from both the business valuation and real estate appraisal perspectives. **Contact: valexcel@cox.net.**

Some Helpful Publications on Valuation Methods for Undivided Interests

The following publications focus on the methods used for valuation of undivided interests without getting bogged down in specific court case facts and decisions. They are just a small sample of the more recent publications on the subject.

Katherine A. Gilbert and C. Ryan Stewart, "Valuing Real Estate Fractional Ownership Interests," *Insights* (Summer 2010): 80–92, http://www.willamette.com/insights_journal/10/summer_2010_12.pdf.

Lance S. Hall, "Tax Valuation—Undivided Interest Discounts," *Journal of Practical Estate Planning* 9, no. 2 (April–May 2007): 11–14.

Lance S. Hall, "Undivided Interest Valuations," *Valuation Strategies* 10, no. 6 (July/August 2007): 33–34.

Robert F. Reilly, "Valuing a Real Estate Undivided Interest in the Marital Estate," *American Journal of Family Law* 24, no. 3 (Fall 2010): 157–163.

Ted Israel, "Discounts on Undivided Interests in Real Estate," *Valuation Strategies* 6, no. 5 (May/June 2003): 47–51.

Dennis A. Webb, "Your Master Key to Winning Fractional Interest Valuations" (presentation, 2015 Appraisal Institute Connect Annual Meeting, Dallas, TX, July 28, 2015).

Ronald M. Seaman, "Valuation of Undivided Interests in Real Property," *Business Valuation Review* 16, no. 1 (March 1997): 32–40.