Minority Interest Discounts

Are They Appropriate in Valuing Noncontrolling Interests in Real Estate Holding Companies?

By Martin Greene

Are minority interest discounts appropriate in valuing noncontrolling interests in real estate holding companies? Because trust and estate professionals might find themselves answering this question differently from the IRS, the issue requires close examination.

Noncontrolling interests in real estate holding companies are those for which the holder cannot exercise prerogatives of control, such as determining policy. It is assumed for this discussion that there is no immediate expectation that the underlying property will be sold.

Valuation Approaches

The following three approaches in valuing businesses, real estate, and other investments are generally recognized by appraisal organizations and the professional literature:

- Asset approach
- Income approach
- Market approach.

The asset approach focuses primarily on the net assets of the business. The income approach principally involves the use of earnings or cash flows to estimate value. The market approach relies on direct comparisons with other transactions in a same or similar industry. IRS Revenue Ruling 59-60 states that the value of a real estate holding company is closely related to the value of the assets underlying the stock; however, such an approach can be less relevant when valuing a real estate holding company in which management is actively involved, because such involvement reflects the attributes of an operating company, rather than a holding company. Nonetheless, business appraisers have continued to use a type of asset approach—the "net asset value" (NAV) method—to value real estate holding companies, regardless of the level of control.

NAV method. This approach adds together the total value of a holding company's assets—including the appraised value of its real estate, cash, and other assets—and subtracts its liabilities. The NAV is generally considered to be the net value that could be realized by a controlling interest, excluding liquidation cost (Bruce A. Johnson, Spencer Jeffries, and James R. Park, *Comprehensive Guide for the Valuation of Family Limited Partnerships*, 3rd ed., Partnership Profiles Inc.). When valuing these noncontrolling interests, business appraisers have simply applied discounts to the NAV in order to account for the interest's lack of control and marketability.

Real estate limited partnerships (RELP) trade in the secondary market at discounted prices compared to their NAVs. Business appraisers often consider these discounts a proxy for lack-of-control discounts for closely held real estate holding companies. In performing valuations, business appraisers have selected discounts from averages of surveys of these publicly traded RELPs, or they have used precedent from court decisions of similar real estate holdings.

Although these average discounts might appear appropriate, the individual discount for each RELP can vary widely. Partnerships Profiles Inc., widely recognized as an authority in compiling RELP data, publishes an annual survey of price-to-NAV discounts based on current RELP and certain real estate investment trust (REIT) transactions. In a recent publication, it reported discounts for the category "partnerships with moderate to high debt," ranging from a low of 19% to a high of 50% ("2012 Executive Summary Report on Partnership Re-Sale Discounts," 2013). Factors affecting price-to-NAV discounts can be complex, and averages can be misleading. The specific discount factors include the time from the transaction date to the expected partnership liquidation date, size and debt structure, distribution policies, and management—all of which might not be evident from survey averages.

Relevant Court Cases

Court decisions can be even less precise, depending upon the specific expert testimony and evidence presented at trial. In *Mooneyham v. Comm'r* (TC Memo 1991-178), the inability of the taxpayer's expert to support a particular discount for a fractional interest in real estate resulted in the Tax Court rejecting the expert's opinion and choosing a lower discount. The Tax Court opined:

> Although claiming to be a real estate appraiser, [he] did not give an opinion of the value of the whole property. His report set out various reasons why a 15 to 30% discount for a fractional interest of property would be appropriate. Neither his report nor his testimony at trial gave any reason for choosing 25% as applied to the property in issue.

In *Pierre v. Comm'r* (TC Memo 2010-106), the Tax Court allowed a 30% marketability discount for a holding company whose portfolio was limited to marketable securities after the IRS challenged the taxpayer's second expert, who advocated for a 35% marketability discount. The IRS failed to argue against the original expert's 30% discount when this discount was actually used in the original report.

Business appraisers should remember that the magnitude of previously allowed discounts is based upon the specific facts and circumstance of each case; thus, they should not assume that discounts opined by the Tax Court in one case will be provable in all situations. The following was elucidated in *Estate of Berg v. Comm'r* (TC Memo 1991-279):

The fact that the petitioner found several cases which approve discounts approximately equal to those claimed in the instant case is irrelevant. Therefore, in deciding the appropriate discounts in the instant case we will take into account all relevant facts and circumstances of the petitioner's interest … and do not consider the amount of discount[s] applied in other cases cited by petitioner as persuasive.

Cash Flow Approach

The NAV method has little bearing on how rational investors make investment decisions. Investors purchasing a noncontrolling interest make decisions based primarily upon the risks and the future rewards of ownership. Investors consider expected cash flows and risks relating to liquidation of their interest in the future. They do not typically engage real estate appraisers to value the property and then select an appropriate discount.

Any investor buying a noncontrolling interest in a company holding real estate is not entirely unlike an investor in any other operating business, such as an attorney joining a law firm or a CPA buying into an accounting practice. The investment decision is based upon expected cash flows and risks affecting ownership of the interest. In the same way, the investment decisions affecting a noncontrolling interest are not generally based solely on the underlying asset (i.e., whether it is real estate or a client relationship). Using real estate as the underlying asset is generally less risky than goodwill, and the lowered risks should be reflected in the discount rate, not in the selection of the valuation approach.

The NAV method for valuing noncontrolling interests in real estate holding companies is assumed to be appropriate by many CPAs and attorneys who engage business appraisers, and they will frequently ask about the size of the noncontrolling discount in advance of engaging the appraiser. Even the IRS might expect this approach, because it asks about the size of the minority discount in estate and gift tax returns. But it is surprising that many business appraisers still simply apply the NAV method without any consideration of a cash flow approach.

A study from the mid-1990s supports the notion that cash flow provides a more robust measure than using a price-to-NAV approach (Bruce A. Johnson and James R. Park, "Limited Partnerships Discounts—Observations from the Secondary Market," *Business Valuation*, vol. 16, no. 2, 1997, p. 62). The study summarizes data of 20 income-producing RELPs, all with histories of paying distributions and with no announced plans to liquidate. The discount from the NAV method at which the interests traded varied between 22.0% and 59.3%, much like the annual price-to-NAV discount studies cited previously, with significant deviations in price; however, the yield-to-price of each RELP was relatively similar, with little deviation between the individual partnerships.

Some would question the necessity of the income approach by business appraisers, given that real estate appraisers frequently apply this same method; however, inputs usually vary, yielding different valuation conclusions. Real estate appraisers consider the revenues and expenses from the vantage point of the underlying property itself, whereas business appraisers consider these amounts from company operations. To a real estate appraiser, stabilized revenues and expenses are those that a buyer of the property would expect, assuming full control, without synergies. The revenues and expenses applied by business appraisers assume continued operations because the willing purchaser of a noncontrolling interest does not have the authority to change policies or the capital structure of the holding company entity, a very dissimilar purchaser with very dissimilar rights.

Real estate appraisers might estimate expenses, such as insurance and repairs, based upon statistical averages or studies relative to geographic area; however, the actual expenses might differ because they reflect management's individual preferences. Real estate appraisers generally assume an optimum capital structure with debt financing of 60%–80% of value. Many controlling owners of holding companies choose not to use debt financing, which raises the cost of capital and lowers the entity's value. A noncontrolling interest holder could not alter this policy.

Market Approach

Another approach that business appraisers should consider is the market approach, which is based upon the theory of substitution. It postulates that rational investors will pay no more for an investment in the subject business than they would have to pay for a similar investment, if available. Therefore, as in valuing a business, the market prices of publicly traded guideline companies' transactions involving comparable real estate–related companies or REITs are utilized to determine the value of an interest in a real estate entity. In applying the market approach, several multiples are developed to apply to the subject entity's financial information.

Rather than considering the average of price-to-NAV studies, the market approach involves selecting individual guideline partnerships that should contain attributes similar to the subject holding company. Guideline partnership multiples can be applied to the subject holding company's fundamentals. The criteria used to select guideline partnerships can include those with similar distribution policies, capital structure, and type of real estate held; however, aside from the obvious difference that guideline partnerships are publicly traded and the subject company is closely held, some characteristics are unique to privately held entities.

Frequently, privately held entities have assets with a lower inside cost basis and the real estate held is more fully depreciated, whereas the guideline partnerships can have significant depreciation deductions. In New York City, valuations can include S corporations, which are subject to local corporation taxes and not generally applicable to the guideline partnerships. Merely applying discounts to NAV based on publicly traded RELPs would not measure the dynamics of these and other specific company factors on value that would be considered by a potential investor. By applying the market approach, however, business appraisers can quantitatively normalize or adjust the guideline companies' multiples for these factors. The market approach allows for valuation adjustments to be applied to these multiples; when applying the NAV method, on the other hand, adjustments might be somewhat subjective or might develop what is effectively an application of the market approach.

Comparing Approaches

Under the asset or cost approach, generally only a single multiple is considered: price to NAV. The multiple used is from surveyed partnerships, which might have little relationship to the subject entity. In addition, there can be a significant variation in the minority discount, depending upon the selected RELPs in the survey category. Under the market approach, on the other hand, the selection of guideline partnerships is made under very selective criteria. There are more multiples to consider, and cash flow—considered the most significant factor—can be evaluated.

Partnership Profiles Inc. advises applying the same approaches described in this article. Although it published the aforementioned study, it does not necessarily claim that the NAV method will provide the best method for estimating noncontrolling interest discounts. In addition, the income approach often mirrors investors' thinking with respect to the cash flows and potential risks of the investment.

Real estate appraisals are an important component of the valuation process; thus, it would be unwise to advocate eliminating or minimizing these appraisals. They are necessary for the NAV method, and the courts have mandated their consideration. Real estate appraisals can provide insight in estimating ongoing revenues and expenses, as well as economic risks. Furthermore, because the lives of these entities are not indefinite, liquidation issues that arise in the business valuation of these holding companies and in real estate appraisals can be used to estimate value when the NAV method is appropriate. Under the income approach, distributions to stakeholders from the refinancing of debt may be considered a cash inflow. Real estate appraisals can be used to help measure the potential borrowing availability of the subject company. Underlying real estate appraisals can be used to estimate certain multiples and provide a terminal value under the income approach.

This article presumes that the holder of a noncontrolling interest cannot force the sale of the underlying real estate property, and little expectation exists that the property will be immediately sold. As the prospects of the underlying property's sale and liquidation of the interest increase, however, the NAV method can become more appropriate. If the sale of the underlying property and liquidation of the company are imminent, the NAV method is generally apposite, regardless of the level of control, without applying any minority discounts.

Examples from the Courts

In *Estate of Andrews v. Comm'r* (79 TC 938), the decedent owed interests of approximately 20% each in four separate companies that were primarily involved in the ownership and active management of commercial real estate properties. In this case, the court was critical of the experts for not giving appropriate weight to net assets, as well as earnings and dividend capacity methods; the court made its own best judgment of value:

> The degree to which the corporation is actively engaged in producing income rather than merely holding property for investment should influence the weight to be given to the values arrived at under the different approaches.

In *Estate of Weinberg v. Comm'r* (TC Memo 2000-51), which addressed the value of a limited partnership interest in a residential apartment building, the petitioner's expert applied both the capitalization of income approach (as cited in the court opinion) and the NAV method, weighing their concluded values (75% and 25%, respectively) to determine the value of the limited partnership interest. The IRS's expert only used the capitalization of income approach; he stated that the NAV method was inappropriate for valuing the subject interest because the underlying property was income-producing real estate. The court, however, held that the NAV method should still be considered because the value of the underlying real estate would retain most of its inherent value if the limited partnership interest were not efficient in securing a stream of rental income. In its conclusion, the court agreed with the petitioner's expert, weighting the value between the two methods of 75% and 25%, respectively.

In *Estate of Guistina* (TC Memo 2011-41), which involved a limited partnership interest of a company primarily consisting of operating timberlands, the court resolved that two methods are appropriate: the cash flow method and the asset method (NAV method). The court opined as follows:

> The cash flow method is appropriate to reflect the value of the partnership if it is operated as a timber company and the asset method is appropriate to reflect the value of the partnership if its assets are sold. Accordingly, the percentage weight to be accorded the cash flow method should be equal to the probability that the partnership would continue to be operated as a timber company.

It accorded a 75% probability to its continued operation, applying a cash flow method rather than a liquidation of assets using an NAV method. Furthermore, the court did not accord a lack of control discount to either method; it indicated that the discount was subsumed in the weighting. It is helpful to consider that the court was critical of the guideline companies selected by the petitioner's expert and applied no weight to the market approach.

Implications

The question asked at the beginning of this article was, "Are minority interest discounts appropriate in valuing noncontrolling interests in real estate holding companies?" Applying the income and market approaches to noncontrolling cash flows and guideline company multiples or to transactions that are noncontrolling can provide a minority-level value and eliminate the need for separately calculating a minority-level discount.

A minority interest discount can still be determined by comparing the entity value determined by the business appraiser before other discounts, including a marketability discount to the NAV. A large variation, whether between individual approaches in the business valuation or between the valuation and the real estate appraisal, requires further analysis. Regardless of the ultimate disposition, a reconciliation of the different approaches in a business valuation will result in a more thorough and comprehensive analysis than merely deducting a fixed percentage from the appraised value. ❑

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