DISCOUNTS

Discounts to Consider in Valuing Partial Interests in Real Estate

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Discounts for income taxes on "trapped in gains," as well as discounts for lack of control and lack of marketability can result in substantial reductions in the value of real estate holdings, and therefore the ultimate income taxes owing. However, because judgment is required when selecting the discount applied, the discount used can be challenged. This article presents guidance on discounts typically applied in the valuation of partial interests in real estate, as well as studies and specific factors to consider in selecting and supporting an appropriate discount.

The first step in valuing full or partial interests in real estate is typically to obtain a real estate appraisal. Once the appraisal is obtained, the book value of the real estate is adjusted to its appraised value. Next, adjustments are made for any other differences between the book value and market value of other assets held in real estate companies or entities. Finally, consider whether discounts should be applied to the value arrived at, and if so, the extent of such discounts.

Three discounts, which are commonly considered, and potentially applied to real estate holdings comprise:

1. Discounts for income taxes on trapped in gains.
2. Discounts for lack of control.
3. Discounts for lack of marketability.

The *Jelke* case[1] in the United States provides an example of how the courts may view the selection of discounts. In *Jelke*, the Eleventh Circuit Court allowed a full discount for the built in capital gains tax liability on the basis that this approach "... eliminates the crystal ball and coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking."[2]

Below is a more detailed overview of each of the three types of discounts and the approaches available to determine the appropriate discount to use.

1. Discounts for Income Taxes on Trapped in Gains

This represents the discount for income taxes owing on the difference between the anticipated net proceeds from the real estate as at the valuation date, and the cost (or adjusted cost base) for income tax purposes. There is typically both a capital gain and a recapture component on a gain.

The three approaches to reflect the income taxes on trapped in gains are as follows:

1. Deduct the full income tax liability existing at the valuation date.
2. Discount, or present value the income tax liability based on the anticipated timing in which the income taxes will be paid (or include 50% of these expenses to reflect timing uncertainty).
3. No deduction reflected. This implicitly assumes an indefinite holding period.

These three options present the full range of potential results, from recognizing the full income tax liability on the valuation date (option 1) to recognizing no deduction for this potential income tax liability on the valuation date (option 3).

In our experience, the second option is used most often as it takes into account the anticipated timing in which this liability will be realized. However, there have been several cases in the United States where the full liability was recognized on the valuation date. One justification for this approach was noted above in the *Jelke* case in that it removes some

[1] *Estate of Frazier Jelke III*, (2007, CA11) 100 AFTR 2d 2007-5475 cert. denied (2008, S. Ct.) 2008 WL 2481919), as cited in *Estate Planners Alert*, Thomson Reuters/RIA, December 2008, at 3 and 4.

[2] *Estate Planners Alert*, Thomson Reuters/RIA, December 2008, at 4.

of the uncertainty and judgment associated with the valuation.

In calculating the income tax liability, the income tax rate used should represent the anticipated rate that will be applicable on the taxable income. Consider and apply two items when making the calculation:

1. The effects of additional tax that may be owing for Refundable Dividend Tax on Hand ("RDTOH") under the Canadian Income Tax Act.[3]
2. The potential refund of RDTOH (existing balances and additions to these balances).

The treatment of RDTOH should take into account the specific factors of each situation relating to when the income taxes are anticipated to be incurred.

If assets have been held for a long time, it may be necessary to use values as at January 1, 1972 (i.e., Valuation Day), rather than the actual cost when the assets were purchased.

As can be seen from the above analysis, there is a wide range in the potential results. It is generally accepted that a discount should be applied for the income taxes on the trapped in gains. The question typically relates to the extent of the discount.

2. Discounts for Lack of Control

A discount for lack of control is "an amount or percentage deducted from the *pro rata* share of value of 100% of an equity interest in a business to reflect the absence of some or all of the powers of control."[4] These powers of control include the ability to:

- Decide on levels of compensation for officers, directors and employees.
- Decide with whom to do business and enter into binding contracts, including contracts with related parties.
- Decide whether to pay dividends, and if so, how much.
- Make acquisitions or divest subsidiaries or divisions.
- Buy, sell, or hypothecate any or all company assets.
- Determine capital expenditures.
- Change the capital structure.
- Select directors, officers, and employees.[5]

A few factors to consider in determining the size of the discount for lack of control are as follows:

- The size of the shareholding in terms of the absolute percentage owned.
- The size of the shareholding relative to the size of other shareholdings.
- The number of other owners.
- The relationship of the owner of this interest to the other owners.
- Prior transactions involving interests in the entity, or comparative entities.
- Historical and anticipated distributions.
- Terms of existing shareholder or other related agreements that either provide for "put" rights allowing the holder to sell their interest, or that contain restrictions on the transfer of an interest.
- Consideration of the relevant oppression regulations that may reduce the disadvantages associated with a lack of control.

3. Discounts for Lack of Marketability

Marketability refers to "... the ability to quickly convert property to cash at minimal cost."[6] A discount for lack of marketability is a discount deducted from the *pro rata* share of a business or asset (i.e., a real estate holding) to account for its lack of marketability.

Another way of thinking about a discount for a lack of marketability for a partial interest in real estate is that it reflects the disadvantages of a non-marketable interest compared to an actively and freely traded interest in real estate. A discount for lack of marketability associated with a partial interest in a real

[3] R.S.C. 1985, c. 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[4] Source: *CICBV Glossary of Business Valuation Terms.*

[5] Source: The list of prerogatives of control included in Shannon P. Pratt, "Business Valuation Discounts and Premiums," at 20. We have included the factors considered to be most relevant to the valuation of real estate. Therefore, this does not comprise the full list.

[6] Source: *CICBV Glossary of Business Valuation Terms.*

estate entity considers the following disadvantages:

- There are usually few transactions involving a subject entity, so there is uncertainty as to the ultimate price that will be obtained.
- There is uncertainty as to the timing in which a sale would occur since there is not an active market for these interests.

The significant factors to consider in determining the size of the marketability discount are as follows:[7]

- The size of historical and anticipated distributions. Studies have shown that the discount to net asset value is lower on interests that provide higher ongoing distributions. Details regarding these studies are set out in further detail below (see empirical studies).
- Prospects for liquidity in terms of the anticipated holding period of the underlying assets. When liquidity is anticipated within a shorter time period through, for example the liquidation of assets and the distribution of proceeds, the discount is reduced.
- The potential buyers for this interest. The larger the number of potential purchasers, the smaller the discount since there is a greater likelihood that a sale will be completed within a short time period at the price anticipated.
- Risk factors affecting the investors' required rate of return during the holding period that will affect the discount rate used to calculate the present value of the anticipated returns and/or the required return from this investment. The greater the risk associated with an investment, the more difficult it will be to find a buyer.
- Growth prospects for the value of this interest will affect the eventual potential sale price, (i.e., terminal value). To the extent that there is the potential for growth in earnings, this may reduce the discount for lack of marketability since higher proceeds on sale are anticipated if and when this growth occurs.
- Terms of existing shareholder or other related agreements that either provide for "put" rights allowing the holder to sell their interest, or that contain restrictions on the transfer of an interest.

Relevant Studies

Several studies provide empirical evidence regarding discounts observed in the market. Of direct relevance in valuing real estate is a study conducted by Partnership Profiles, Inc., which compares the market value to the trading price of non-controlling interests in SEC registered but non-publicly traded real estate limited partnerships. Information regarding these limited partnership interests is available from 1993 onwards.

Discounts for Lack of Control and Lack of Marketability

The Partnership Profiles, Inc. study separates its findings into five categories of real estate partnerships:

- Equity – distributing (low or no debt).
- Equity – distributing (moderate to high debt).
- Equity – non-distributing.
- Undeveloped land.
- Triple net lease.

The average discounts for these categories from 2000 to 2008 range from 17% to 37%. As would be expected, discounts on equity distributing partnerships with low or no debt and triple net lease properties were lower than for equity non-distributing partnerships and undeveloped land partnerships. In addition, the partnerships with higher yields traded at a smaller discount to net asset value.

The authors of this study are of the view that most of the discount relates to the lack of control rather than the lack of marketability associated with these interests. Typically, sellers receive payment for their units within approximately 45 days. Therefore, there is some uncertainty as to the timing of the payment not whether a buyer can be found since there is an active market for these units.

[7] Source: These factors other than the last item are based on the factors set out in Shannon P. Pratt, "Business Valuation Discounts and Premiums," at 153.

The Partnership Profiles, Inc. study contains detailed data regarding individual partnerships. Therefore, as a refinement, it is possible to analyze the discount data and develop comparables. To compare a subject property or group of properties in Canada to the findings from this study, it may be necessary to take into account potential differences, including:

- The subject partnerships are located in the United States.
- The subject partnerships may own more properties in a wider geographic area.
- The holding period of the real estate as well as plans to wind up the partnership and distribute the funds. This study notes an inverse relationship between the size of the discount for lack of control and lack of marketability and the anticipated holding period.
- Differences that exist between the ownership of the subject real estate company and the entities included in the Partnership Profiles, Inc. study. For example, the company being valued may have more or fewer shareholders.
- The extent to which the interest being valued compares with the partnerships included in this study in terms of their degree of marketability and control of the individual interests. Specifically, the extent of the discount for lack of marketability in this study is considered relatively low. Therefore, a subject interest may have a higher discount for lack of marketability associated with it.

While the above-noted differences may require adjustment, this study provides useful guidance regarding discounts that may be applicable to other real estate holdings.

Several other studies have also dealt with discounts for lack of control and lack of marketability, as outlined below.

Discounts for Lack of Control

The studies typically used in assessing discounts for the lack of control for a minority ownership interest are based on premiums paid in the acquisition of companies compared to the trading value of marketable minority interests. These studies frequently identify large premiums paid on the acquisition of control. However, there is also a large range in the premiums paid in these transactions.

These studies are not considered directly relevant to the valuation of partial interests in real estate entities because they deal with operating companies where a significant portion of the value relates to goodwill. In addition, there is a wide range of results, some of which may relate to anticipated synergies, which is more relevant in operating companies than in real estate companies.

Discounts for Lack of Marketability

Studies that are commonly used in calculating discounts for lack of marketability are as follows:

(a) Restricted stock studies that compare the prices of restricted stock in public companies to public market trading prices. Discounts based on the restricted stock studies were generally in the range of 33% to 35% until 1990, after which discounts decreased because SEC regulations loosened restrictions on restricted stock.

(b) Pre-IPO studies that compare the prices of private transactions in companies prior to an initial public offering to the initial public offering prices.

These studies typically relate to operating companies rather than real estate companies. Therefore, while they can be used for guidance, they may not be directly relevant.

Reasonableness Test

Calculating the yield that the real estate investment would generate based on the value arrived at relative to the anticipated income is a useful test to determine the reasonableness of a discount. If the yield is either too high or too low, the discounts used may require adjustment.

The income used as a basis to calculate the yield can be either distributed income (i.e., cash) or accounting income. The Partnership Profiles, Inc. study includes data on yields from the partnership interests. Data regarding yields from publicly traded REITs can also form a basis of comparison.

Conclusion

When selecting discounts for partial interests in real estate entities, there are several relevant factors to consider, including trapped in gains, as well as discounts for lack of control and lack of marketability. To support the discounts used, several studies and approaches offer helpful guidance.

When selecting the ultimate discount used, carefully consider the specific facts associated with the interest being valued to determine the most important factors that will ultimately affect the value assigned to a real estate asset.