

HG&G UPDATE

Hofheimer Gartlir & Gross, LLP

WINTER 2009

DETERMINING MINORITY DISCOUNTS IN PARTIAL INTEREST PROPERTY OWNERSHIP

In partial interest ownership of real property, an important question arises as to whether the parties are entitled to a minority discount in the context of estate planning, real estate taxes, the re-sale process or any other transfer of the property in question. If the parties are entitled to a minority discount, the questions become how much of a discount and how that discount is determined. The range of minority discount amounts varies greatly depending on numerous factors and must stand up under scrutiny by the government, whether in a court of law or by the IRS, making the process used in the determination of minority discounts a crucial one.

Inaccurate minority discounts, as determined by a governing entity, may result in higher tax penalties or other fees in the transfer of property. It is challenging to find an overarching pattern to guide attorneys and real estate appraisers on the specific amount of minority discounts.

RATIONALE FOR MINORITY DISCOUNTS

Partial interest property ownership (the division of rights associated with the owning or using of real estate) manifest itself in a number of forms. Real property may be held as a limited partnership interest, general partnership interest, REIT, joint tenancy, tenancy in common, tenancy by the entirety, family trust, or as units of ownerships in a limited liability company.

A minority discount is a reduction in value of partially owned property from the fair market value of the whole property due to lack of controlling interest in the ownership entity and the lack of marketability of that interest.

There are a number of instances when creation of partial interest property ownership might be favorable. It is common practice in estate planning to use the minority discounts associated with partial interest ownership to effectively reduce estate and gift tax in the transferring of

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wealth from one generation to another. (See our Winter 2007 Newsletter)

However, the legal and valuation principles used in determining these discounts have come under increasing scrutiny from the IRS. Audits of gifts involving limited partnership interests and other types of partial interest ownership have increased in recent years. The IRS has in several instances disallowed a claimed discount where a family limited partnership was formed shortly before the death of an individual in what was determined to be an artificial attempt to depress the value of the individual's assets. The overarching rule guiding this decision making is that certain kinds of limited partnerships must be established for legitimate business purposes, not for the sole purpose of reducing estate taxes.

The rationale for minority discounts for partial interest ownership of property is based on two main factors. First, that partial interest ownership allows for fewer benefits than a controlling ownership, and second, that partial interest in property translates into lack of marketability.

Non-controlling partial interest owners have no control over the management decision process involving the property and therefore do not benefit from the same bundle of rights that accrue to the controlling ownership position, such as decisions about refinancing and distributing excess proceeds.

Lack of marketability is a slightly different, but related, issue from lack of control in decision making and arises from the very limited resources through which partial interests, particularly non-controlling ones, can be sold. Partial interests are not actively marketed by the vast majority of real estate brokers since they are not particularly desirable to buyers. As a result, the owner of a partial interest has extremely limited resources available to market the asset. The discount for lack of marketability takes into account the added time, cost and difficulty of marketing a partial interest property.

Courts have upheld the distinction between loss of value from partial interest ownership and lack of marketability due to partial interest ownership.

DETERMINING MINORITY DISCOUNTS

There are three methods for determining value of partial interest ownership. The comparable sales method involves the valuation of a partial interest by comparison to unit prices paid for similar partial interests in the same property or group of projects. These sales are infrequent and adjusting them for typical appraisal factors such as market conditions, future growth, balance sheet differences and other assets is extremely difficult. A second method is dividend capitalization, which involves the determination of future equity cash flow and partnership distributions. The difficulty with this method involves the derivation of a capitalization rate, which is wholly separate and distinct from a rate derived from real estate transfers. The third method, fractional discounting, is the most commonly utilized in valuing minority real estate interests because the determination of property value, discount value and discount rate is property specific.

The fractional discounting technique is a widely recognized technique in determining the fair market value of a minority interest in a real estate partnership. It involves three basic steps. First, determine the fair market value of the underlying asset; second, calculate the fractional interest's pro-rated share of the asset; and third, and most complicated, determine and apply a fractional interest discount, or minority discount, to the pro-rated share.

Numerous authorities support substantial discounts in a partnership or closely held corporation due to lack of marketability and liquidity of the interest, the inability of a limited partner to vote on matters such as cash flow distributions and restrictions that further limit salability. All

of these items could potentially result in substantial reduction in value.

CONCLUSION

Assets and property should be appraised by a qualified valuation consultant in accordance with the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Foundation, which is authorized by Congress to set appraisal standards and qualifications. In some cases, as in when an individual expects to make gifts of additional limited partnership interests each year, it is wise to update the appraisal annually.

The best way to secure the most accurate minority discount is through the expertise of a well-credentialed, accredited senior appraiser. This typically means a professional with a Member of the Appraisal Institute, or MAI, designation. Such a designation indicates an appraiser has passed substantial levels of education, qualifying examinations, and has obtained significant expertise and experience in the valuation and analysis of commercial, residential, industrial and other types of property, and in advising clients on real estate investment decisions. Typically, courts and IRS have not been inclined to dispute someone with these credentials.¹

TENANT RELIEF

In the current economic climate, business owners, especially those in a retail business, need to increase the share of dollars being spent on their products and reduce expenses to maintain profitability. Cutting an advertising budget is not a good solution as it would probably also reduce sales. Cutting other expenses may be helpful, but difficult. These types of cuts would include reducing payroll and negotiating price reductions with suppliers.

Based on media coverage, there is a perception, not necessarily true, that landlords are willing to reduce rents to assist their tenants. The business owner generally has four options to alleviate his rent obligation, the first of which is seeking a temporary rent reduction. Landlords are not however inclined to do this as they also have expenses to cover. A second and more potentially available option would be seeking a rent deferral. For example, a tenant could ask that its rent be reduced by \$2,000 per month for six months and then repay the \$12,000 reduction at \$1,000 a month over the next twelve months. Another tenant option is to reduce its space.

Subletting or giving space back to the landlord will take time and may not be successful. The final option is to spread payment of real estate taxes and common area charges or operating expenses over the full year in question, rather than paying them in a lump sum annually or semi-annually.

From the landlord's perspective, across the board rent reductions would not be the norm. A landlord should not grant any relief unless the tenant shows some evidence of the need by opening its financial records to the landlord. The landlord should also consider meeting with the tenant to determine what the problem is and how the tenant proposes to solve it with landlord's participation. This may include a change in tenant's business model and a discussion of how long the turnaround time may be. If a deferral is granted, the landlord may want to condition it on receipt of a personal guaranty of the deferred amount by the principals of tenant. In any event, the landlord must determine whether any mortgage on the property re-

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quires the lender's approval of lease modifications.

Landlords can also reduce tenant costs by renegotiating their service contracts and by reducing services, the costs of which are reflected in common area charges or operating expenses paid by tenants. A cleaning service that is provided five times a week could be reduced to four. Painting of common areas could be deferred from every

three years to every four or five years. Dusk to dawn lighting could be reduced so that lighting is provided only for security and not for decorative purposes when buildings or shopping centers are closed.

If you own real property or are a tenant, you may wish to discuss these upcoming issues with an HGG real estate partner.

ROADBLOCKS TO ADVERSE POSSESSION: ANTIQUATED STATUTE GETS A MODERN MAKEOVER

On July 7, 2008, the New York State Legislature enacted revisions to its adverse possession statute, Real Property Actions and Proceedings Law ("RPAPL") §501, *et. seq.* which make a successful claim of adverse possession more difficult to prove and which prevent claims of adverse possession in cases of minor, non-structural encroachments. With the revisions, lawmakers attempt to strike a balance between the rights of land owners and the practical reality of inconsistencies and irregularities that often arise in the use and conveyance of property. However, the revisions may present new issues for mortgage lenders, title insurers and property owners.

Adverse possession is a theory of law by which a person occupying property that belongs to another may acquire title to the property merely by virtue of his or her occupation of the property. This surrender of title to the property occurs without the true owner taking any action to effectuate the transfer of title. A claim of adverse possession arises when the occupant, or adverse possessor, remains in possession of the property for the statutory period (which is ten years, in most cases), and when a number of other conditions are met.

Prior to the recent statutory revisions, the adverse possessor was required to show that his or her occupation of the property was "hostile and under claim of right, actual, open and notorious, exclusive and continuous for the statutory period." These factors, were previously undefined by statute.

The revised Section 501 of the RPAPL provides that an adverse possessor acquires title to the adversely possessed property after the expiration of the statutory period, "provided that the occupancy...has been adverse, under claim of right, open and notorious, continuous, exclusive and actual."

The revised Section 501 includes a newly explicit definition of the term "claim of right," which means having "a *reasonable basis for the belief* that the property belongs to the adverse possessor or the property owner, as the case may be." Therefore, a claim of right (and, thus, a claim of adverse possession) can arise only where a reasonable person in the position of the adverse possessor would believe that he or she has a right to legally occupy the property, despite the fact that record ownership

could be determined by an examination of the County Clerk's records. Judicial application of this standard is untested, but the revised statute appears to be a substantial obstacle to a successful adverse possession claim since, in most cases, a "reasonable" person would be expected to check the public records before using or taking an interest in property. The newly-defined "reasonable" standard for a claim of right prevents a would-be adverse possessor from claiming a legal interest in property where he or she was occupying the property without some basis for believing that he or she was, in fact, the true owner of the property.

In addition to the revisions discussed above, the New York State Legislature also added a new Section 543, which provides:

(i) the existence of de minimus non-structural encroachments, including, but not limited to, fences, hedges, shrubbery, plantings, sheds and non-structural walls, shall be deemed to be permissive and non-adverse; and

(ii) the acts of lawn mowing or similar maintenance across the boundary line of an adjoining landowner's property shall be deemed permissive and non-adverse.

Purchasers of property and lenders now have little ground for concern if such encroachments burden the property in which they intend to take an interest, since the encroachments are deemed permissive and, thus, will never ripen into a claim of adverse possession.

DON'T HIDE FROM THE IRS

This may seem counter-intuitive to many. However, IRS should have a current address for anyone who files a return. You cannot rely on the post office to forward mail. You may lose your stimulus check or that rare refund if the IRS can not reach you. We have also found that upon death of a taxpayer the IRS may still be corresponding to an address no longer valid. In one instance, additional gift taxes were due. By the time the executor found out interest and signifi-

cant penalties had accrued.

In the event of death of a taxpayer your accountant or attorney can file a form to notify IRS to contact the firm so that no notices are missent or returned. Your HGG partner will discuss this with the legal representative of an estate or trust as a matter of due course.

If you think IRS does not know where to find you or someone you represent please talk to a partner at the firm.

COMMON CHARGES ON UNSOLD UNITS

The New York Condominium Act requires that a Sponsor pay common charges on unsold condominium units beginning at the same time that the holders of purchased units start paying common charges. This obligation is also required by the Attorney General's regulations. A Sponsor with a large number of unsold units will at times de-

fer the initialization of common charges rather than pay such charges on all unsold units. This rule applies whether the condominium consists of one building or townhouse units. A townhouse project can be built in separate phases, each its own condominium association, thus limiting the Sponsor's obligation if the devel-

opment is not going to be built all at once.

In a recent case in which we represented the Condominium, the developer waited decades before starting to develop the last 32 of 75 planned townhouse units, relying on the by-laws it drafted which exempt it from paying common charges on the unbuilt and unsold units. The Appellate Division recently held that the Condominium Act takes precedence over the exemp-

tion set forth in the by-laws and refused to allow the fact that the Attorney General's Office had mistakenly approved the original offering plan and amendments allowing the exemption for unsold and unbuilt units to exempt Sponsor from its obligations set forth in the Condominium Act. For further information, please contact Sharon Zimmer or David Birch or another partner at the firm.

●HGG BANKRUPTCY PRACTICE

• We are pleased to announce that Allen Levine is now part of our bankruptcy, insolvency and creditors' rights group. He joins Nick Malito and Partner Scott Kipnis. Their bios can be found in the attorney profiles link on our website, www.hgg.com.

This group is heavily involved with issues at numerous Circuit City locations, representing owners, landlords, subtenants and other creditors. If a business you deal with files for bankruptcy proceedings, talk to our bankruptcy group about preference claims and protecting your interest.

About Hofheimer Gartlir and Gross, LLP

The firm conducts a general commercial practice. Our principal practice areas are:

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts, foreclosures)
- estate planning
- trust and estate administration
- general litigation and alternate dispute resolution
- matrimonial and family law
- taxation
- bankruptcy and creditors' rights

Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families

VISIT US ON OUR Web site: www.hgg.com

Thanks to Jerry Morganstern, our Managing Partner, Suzanne O'Malley and Damon Osborne for their contributions to this issue. - David L. Birch, Editor

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