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ACCOUNTANTS & ADVISORS

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EMINENT DOMAIN: UNDERSTANDING THE "LARGER PARCEL"

When the federal, state or local government acquires (or "takes") a portion of privately owned property under eminent domain, the property owner is typically entitled to "severance damages" for loss in the value of the larger parcel of property that wasn't acquired, in addition to the value of the portion taken. Not surprisingly, the amount the landowner receives can vary greatly depending on what's included in the larger parcel. But how is the larger parcel determined?

The larger parcel concept

When a government takes land, it isn't authorized to take more property than is actually required for its project. As a result, governments typically take land from a larger parcel,leaving the remainder behind.

The term "larger parcel" signifies that the parcel taken by the government isn't a complete parcel in itself, but part of a bigger tract. For example, in a condemnation of a 100-foot-wide street right of way that runs through an 80-acre open space parcel, the 80-acre parcel would be the larger parcel — the parcel that would be negatively affected by the taking.

The allowance of damages based on the severing of a parcel from a larger parcel recognizes that the grouping of separate parcels may produce a value greater than the sum of the value of the individual parcels. The loss of one parcel, therefore, can reduce the value of the remaining parcel(s). The amount of severance damages is determined by a court based on the "highest and best value" of the larger parcel.

Determination of the larger parcel

Even though details vary among states, a larger parcel generally must satisfy three tests:

Unity of use

This is the most important test, and it requires the property (that is, the asserted larger parcel) to be put to a single overall use. The unity of use determination is
usually based on the property's highest and best use and examines the following factors:

- The current property uses,
- The time and expense necessary to terminate
- those uses,
- The current and proposed zoning applicable to

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- the parcels,
- The physical adaptability of the property for use as an integrated whole,
- The property owner's development plans,
- The local regulatory climate, and
- The local market conditions.

As these factors suggest, the determination must take into account both the property's current state and its reasonably probable future uses. Current unity of use isn't necessarily required; courts will consider whether future unity of use is likely. In other words, what matters is if it's reasonably likely that the property would be available for development as a single economic unit in the near future.

Unity of ownership

Unity of ownership requires that different parcels be owned by the same owner or set of owners. Courts may consider "equitable ownership" (a form of ownership that exists without legal title, such as a right of use) to satisfy this test.

Courts might also look at who controls the various ownership interests — for example, if one parcel is owned by an individual and the other is owned by an S corporation established by that individual, or the first parcel is owned by an individual and the other by his or her spouse. Unity of ownership can exist even if the owner doesn't have the same quantity or quality of interest in each parcel. An owner isn't required to have a "fee simple" interest in each parcel.

Contiguity

The contiguity test requires physical proximity between the parcels that form a larger parcel, reflecting the fact that abutting parcels are more likely to have similar highest and best uses under a single ownership. This test is generally considered the least critical, though. Property has been designated as larger parcels when separated by, for example, a highway, as long as there's access between the parcels and a current or reasonably likely future unitary use.

Get what's coming to you

A government taking of property is unpleasant enough without ending up shortchanged in the bargain. Understanding how to determine the larger parcel affected by the taking can help you maximize your compensation.

SIDEBAR: "LARGER PARCEL" VS. "ASSEMBLAGE"

The larger parcel concept is often confused with another concept known as assemblage. Assemblage, however, deals with parcels that have different owners. With assemblage, compensation for a parcel taken reflects the possibility that assemblage of the parcel with another would have increased its value.

As explained by the US Supreme Court in 1934, "The fact that the most profitable use of a parcel can be made only in combination with other lands does not necessarily exclude that use from consideration if the possibility of combination is reasonably sufficient to affect market value." That is, to recover

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assemblage compensation, it must be shown that the parcels are likely to be developed in the future as an integrated unit and would result in the highest and best use of the property.

THE INS AND OUTS OF DONATING HISTORIC PRESERVATION EASEMENTS

The term “preservation easement” is commonly used to describe a type of conservation easement that is a private, legal arrangement between a property owner and a qualified nonprofit organization or governmental agency for the protection of a historic property. But the IRS often challenges such donations.

Justifying a charitable deduction

The IRS defines a historic preservation easement (sometimes referred to as a façade easement) as a voluntary, legal agreement made between a real property owner (donor) and a qualified easement-holding organization (donee) to protect a historic property by restricting future changes to or development of the property in perpetuity. The qualified contribution of such an easement gives rise to a charitable deduction equal to its fair market value (FMV).

Some easements last for a certain number of years (often referred to as “term” easements) with the interests of the easement-holding organization expiring at the end of the term. This type of easement is commonly required to receive grant funding or financial assistance from state or local governments or nonprofit organizations.

Not every preservation easement contribution, however, justifies a charitable deduction. The FMV of the underlying property must decrease after the granting of the easement. In such cases, a “qualified appraisal” by an appraiser is required to substantiate the deduction. The IRS has noted that common deficiencies revealed in audits of preservation easements include noncompliance with substantiation requirements and use of improper appraisal methodologies.

Placing value on the underlying property

Because preservation easements typically aren’t bought and sold in a market that values them directly, federal tax regulations endorse the indirect “before and after” valuation method to determine FMV. This method values the underlying property before and after the grant of the easement, with the difference representing the easement’s FMV.

An appraiser should, when assessing the “before” value, consider not only the current use of the property but also the likelihood that the property, without the easement, could be developed. He or she should also take into account any effect from zoning, conservation or historic preservation laws that already restrict the property’s “highest and best use.” According to the IRS, an easement is quite likely to have no significant effect on the value of the property if the easement isn’t more restrictive than local preservation laws or other restrictions that are already in place.

For the “after” value, the appraiser should consider the amount of access that the easement allows and the effect the restrictions will have on the property’s value. He or she must also weigh both specific

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restrictions that are imposed by the preservation easement and the specific restrictions imposed by easements on any "comparable" properties used to reach a value.

Be aware that the IRS doesn't recognize any set "safe harbor percentage" (commonly believed to be around 10% to 15%) by which an easement reduces the "before" value of property. The allowable deduction is determined by the facts and circumstances of each easement contribution. The IRS also won't accept an appraisal to substantiate the FMV of an easement if it merely reduces the "before" value by a set percentage without explanation or reference to the property's specific attributes and the easement.

Determining the bottom line

If you're interested in donating a historic preservation easement, make sure you abide by the specific terms and requirements, as an easement's value may vary depending on your state's laws. So work with your accountants and advisors before jumping into preservation easements.

FHA DEVELOPMENTS COULD HIT YOUR BOTTOM LINE

The US Supreme Court recently issued a landmark decision in a case addressing the liability of housing providers under the Fair Housing Act (FHA). The FHA prohibits discriminatory housing decisions based on race, color, national origin, religion, sex,disability or family status. Combined with some news out of the US Department of Housing and Urban Development (HUD), the Court's ruling puts real estate owners, developers and property management companies at greater risk of litigation over housing discrimination.

The Supreme Court case

The case involved low-income housing tax credits distributed by a Texas governmental agency. A nonprofit that assists low-income families in obtaining affordable housing sued the agency for "disparate impact" discrimination under the FHA. The nonprofit alleged that the agency had caused continued segregated housing patterns by allocating too many tax credits to housing in predominantly black, inner-city areas and too few in predominantly white, suburban neighborhoods.

Disparate impact discrimination claims don't require intentional discrimination by the accused. Instead, they assert that facially neutral policies and practices have a disproportionate adverse effect on protected classes.

The major question for the Court was whether the FHA allowed disparate impact claims, or only disparate treatment claims based on allegations of intentional discrimination. HUD has issued a regulation interpreting the FHA to encompass disparate impact liability, and the Supreme Court agreed. It found that recognition of disparate impact claims under the FHA plays an important role in uncovering discriminatory intent by permitting claimants to counteract unconscious prejudices and disguised animus that escape easy classification as disparate treatment.

The Court imposed some limits on the liability, though, including giving defendants leeway to state and explain the valid business interest their policies serve. Further, a disparate impact claim that relies

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on a statistical disparity will fail if the claimant can't point to a policy or policiescausing that disparity. And before rejecting a business justification for a policy, a court must find that the claimant has shown an available alternative practice that has less disparate impact and serves the defendant's legitimate needs. "Policies," the Court said, "aren't unlawful unless they are artificial, arbitrary and unnecessary barriers."

HUD's announcement

About a month after the Supreme Court ruling came down, HUD announced that it was making almost $40 million available to fight housing discrimination as part of its Fair Housing Initiatives Program. Grants will be made to support organizations interested in the enforcement of fair housing laws and policies and educating the public, housing providers and local governments about their rights and responsibilities under the FHA.

Notably, about $30 million will be awarded to help local nonprofit fair housing organizations carry out testing and enforcement activities to prevent or eliminate discriminatory housing practices. Plus, grants of up to $500,000 will be available to help organizations develop and support a national/regional testing program to help identify discrimination in rental and sales transactions.

Be prepared

These developments are likely to lead to a jump in disparate impact discrimination claims by individuals, class action lawsuits and governmental enforcement actions. Now is the time to review your policies for potential discriminatory impact and see that your employees know how to avoid FHA violations.

ASK THE ADVISOR HOW CAN I MAXIMIZE ESCALATION INCOME?

Escalation income can represent a significant portion of an office building's revenue. That means owners should take time to ensure that they're collecting as much of the income as possible.

Reduce billing errors

It's not uncommon for tenants' escalation invoices to have errors, generally because the escalation method applied doesn't correspond with the method specified in the respective leases.

Escalation methods include:

- Base year with "gross up," where the tenant pays a portion of the expenses incurred beyond those incurred in a "base year," with the expenses adjusted to reflect the costs as if the building were fully occupied;
- Expense stop, where the owner's expenses are capped; and
- Stipulated base amount, a hybrid of the two previous methods.

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Applying the wrong method (or the right method improperly) can lead to escalation income "leakage," or expenses that are reimbursable by tenants but nonetheless not recovered.

Smaller companies might lack the internal resources to properly perform the calculations, relying instead on spreadsheet formulas that can be out of date or fail to account for differences between individual leases. Larger owners could run into problems if they use software packages that don't include the applicable methodologies. Both types of owners should institute measures to ensure their calculations reflect the appropriate formulas — for example, by obtaining better software or outsourcing the billing function. Conversely, it can make sense to simply outsource the calculations to a specialist, like Marks Paneth.

Review and restructure your leases

Your lease terms could help mitigate leakage. For example, if your leases all end on the same dates, you might end up on the hook for a larger percentage of operation expenses than anticipated if several tenants opt not to renew. Try to stagger lease expirations. At the very least, carefully track when your leases will expire so you're not caught unprepared. You may, for example, be able to incentivize tenants to add time to their lease terms.

Watch your capital amortizations

Operating expenses aren't the only costs that can suffer some leakage. Amortizations of capital expenditures can have similar issues. For example, tenants are willing to agree to pay interest on new capital expenditures as a way to reduce operating costs — but owners frequently fail to actually charge their tenants interest on escalatable capital expenditures. As a result, the owners miss out on earning a return on their capital investments.

An ongoing challenge

In a multitenant building, you'll likely never recapture all of your expenses through escalation clauses, as vacancies, lease expirations and similar factors make it virtually impossible. Taking the steps discussed, though, can help you recover many of those expenses.

PARTNER PROFILE - MARC M. DESPAGNI, CPA

Marc M. Despagni is a partner with the firm's Real Estate Group. His experience primarily includes serving large, privately-held companies involved in home heating oil, home security, development of gated communities and factoring and asset-based lending. He also performs tax work for several real estate entities. He is based in Marks Paneth's Woodbury, Long Island office.

In addition to his professional activities, Mark is a member of the American Institute of CPAs (AICPA), New York State Society of CPAs (NYSSCPA) and the Institute of Management Accountants (IMA). He is also a member of the Hauppauge Industrial Association (HIA).

When not working on client or firm-related matters, he enjoys spending time with his family and closely following the Islanders and Yankees with an occasional trip to the movies in between. He resides with his family in Massapequa, New York.

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For Further Information

If you have any questions, please contact William Jennings, Partner-in-Charge of the Real Estate Group, at 212.503.8958 or wjennings@markspaneth.com or any of the other partners in the Marks Paneth Real Estate Group.

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