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ACCOUNTANTS & ADVISORS

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THE TAX COURT WEIGHS IN

Lessee's "Project Costs" Payment is Rental Income for Lessor

Monthly rental payments made by a lessee obviously constitute taxable rental income. But rental income can encompass other types of payments, too. If lessors aren't careful, they could end up on the hook for more tax liability than expected, as well as significant penalties. One development company recently learned this lesson the hard way in the case of *Stough v. Commissioner.*

IRS dispute

Stough Development Corporation (SDC) is a real estate development company that's primarily in the business of acquiring and developing real estate for use as plasma collection centers. The company operates as a pass-through S corporation. Talecris Holdings operates plasma collection centers throughout the country. In 2006, SDC and Talecris entered into a development agreement under which SDC would acquire property and construct a collection center to Talecris's specifications.

In 2008, Talecris executed a 10-year lease with a limited liability company wholly owned by SDC's owner. The lease required the lessee to pay monthly rent determined by a mathematical formula based on "project costs" that SDC incurred in acquiring and developing the plasma collection center.

Under the lease, Talecris could elect to pay the lessor a lump sum for any portion of the project costs, which would reduce those costs and, in turn, reduce the rent the lessee owed under the lease. Talecris made a $1 million lump-sum payment in April 2008.

On their 2008 tax return, SDC's owner and his wife reported $1.15 million in rents received in connection with the plasma center rental — the sum of monthly rent and the lump-sum payment. They claimed a deduction for a $1 million "contribution to construct" expense.

In 2010, the IRS began an audit of the couple's 2008 tax return. The agency ultimately issued them a notice of deficiency for the tax year, disallowing the $1 million deduction. The taxpayers appealed.

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Rental income

Although the taxpayers initially reported the lump-sum payment as rental income, they argued on appeal that the reporting was in error and the payment wasn't rental income. Specifically, they asserted that the payment wasn't intended as rent by the parties but rather was meant to reimburse the lessors for leaseholder improvements.

The Internal Revenue Code (IRC) defines "gross income" as all income from whatever source derived, including rental payments received or accrued during the taxable year. As the Tax Court explained, when a lessee pays an expense or obligation incurred by the lessor in bringing the leased property into existence, the lessor receives a direct economic benefit to the extent the lessor is relieved of his or her financial obligation. In such cases, the court said, it need not inquire into the lessor and lessee's intent unless the payments were unrelated to the lease.

In this case, it was indisputable that the lump-sum payment was:

- Made pursuant to the lease terms,
- Optional for the lessee,
- Meant to reimburse the lessor for project costs in bringing the property into existence, and
- Reduced the lessee's future rents.

The payment, therefore, represented payment of the lessor's expenses, the court said, and constitutes rent without the need to inquire into the parties' intent.

Court's concession

The Tax Court conceded that situations could arise where an improvement made by a lessee isn't intended to compensate a lessor. Indeed, an improvement could be worthless or even detrimental to the lessor.

In those circumstances, the parties' intent should determine whether it's rent. Talecris made no leaseholder improvements, though — rather, it exercised its option to make a payment to reduce the amount of project costs for purposes of calculating annual rent.

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Proceed with caution

The proper reporting of rental income to the IRS isn't always as straightforward as it may seem, as the IRS's definition of rental income can extend further than lessors might expect. If a lessor's misunderstanding of what constitutes rental income is discovered during an audit, it could prove costly.

SIDEBAR: COURT UPHOLDS $58,000 ACCURACY-RELATED PENALTY AGAINST LESSOR

The taxpayers in *Stough v. Commissioner* (see main article) ended up shouldering a hefty accuracy-related penalty for their tax return mistakes. The Internal Revenue Code imposes a 20% penalty on any part of an underpayment attributable to a substantial understatement of income tax. A substantial understatement occurs if the amount of understatement for the taxable year exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The penalty doesn't apply if the taxpayers had reasonable cause for their position and acted in good faith.

In *Stough*, the Tax Court rejected the taxpayers' argument that they had reasonable cause because they'd relied on the advice of their CPA. It stated that unconditional reliance on a tax return preparer doesn't by itself constitute reasonable reliance in good faith - taxpayers have a duty to read their returns. Because they chose not to adequately review their tax return, the taxpayers were liable for the penalty.

GET SMART WITH "SMART BUILDINGS"

With smart TVs, cars and appliances becoming more common, it's no surprise that smart buildings are also starting to take a foothold across the country. Some owners and investors continue to resist the trend, but their resistance is often based on mistaken notions about the costs and complexities of smart building systems. The reality is that advances in technology mean the benefits often far outweigh the impediments.

What's a smart building?

Smart buildings feature systems that deliver critical building services — such as HVAC, lighting, sanitation, and security — at a lower cost both financially and environmentally. The systems leverage information technology to connect various subsystems that traditionally have operated independently, enabling the subsystems to share data and maximize total building performance.

For example, a smart building can peg energy output to occupancy (as tracked by the building security system) or weather patterns to cut energy costs. A smart building can also monitor the electricity market and adjust usage according to pricing in order to secure the lowest possible costs. In addition, it can generate revenue by selling backload reductions on the market.

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It's worth noting that smart building technologies aren't just for office buildings. After all, every building has HVAC, plumbing and similar systems that could be optimized.

What are the benefits?

Many people confuse the terms "green" and "smart." While smart buildings typically provide some green benefits (that is, benefits related to energy and sustainability), they also go beyond energy efficiency to address operational issues — such as building and equipment performance and maintenance — that, in turn, allow better capital planning. Algorithms, for example, can detect performance problems and alert facility staff to address these issues, leading to improved performance, extended equipment life and the avoidance of expensive failures.

Smart building technology also allows owners to manage entire portfolios of buildings from a single operations center. Although outside experts will probably be required for the initial installation, in-house employees can easily operate the automated systems going forward. These trained personnel can analyze real-time data to optimize each building's systems performance.

The incorporation of smart building technology can provide valuable reputational benefits and competitive advantage, as many of today's tenants expect their buildings to be "smart." The technology can boost occupancy rates and justify higher rents. Moreover, some municipalities now require public disclosure of buildings' energy efficiency.

What about the costs?

Concerns about the presumed high costs of smart building systems have been the driving force for some owners and investors resisting such systems — but those concerns are largely misplaced. Smart technologies generally come with low upfront capital costs, and buildings armed with smart systems usually cost less to operate than those dependent on legacy systems.

And because the operational and energy-related savings kick in shortly after smart building technologies are installed, investments in the technologies pay for themselves quickly. The return on investment probably begins earlier than ever before in light of dropping technology costs.

For example, the cost of wireless sensors that collect equipment data has fallen to less than $10 per sensor. That means smaller buildings without centralized automation systems can enjoy some of the benefits from smart technologies without incurring the costs of installing hard wiring. These buildings can adopt technologies using a prioritized system-by-system approach based on which upgrades will result in the greatest returns on investment.

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Act now

Smart buildings are bringing dramatic changes to the real estate industry. As owners and investors begin exploring how these technologies can help them and their bottom lines, they'll likely continue to jump on the proverbial bandwagon sooner rather than later.

HOW TO AVOID GETTING BURIED BY YOUR DEBT

Leverage — using borrowed money to make an investment — allows real estate investors to afford more expensive properties than they could with just their own equity. It's an especially attractive option in today's low interest rate environment. And, unlike dividends, interest payments are tax-deductible, further reducing the cost of debt.

But debt repayment can sink a deal if interest rates increase, property values decline or tenants don't renew. When a borrower's cash inflows aren't enough to cover its principal and interest payments, the property is said to be "overleveraged," which can lead to bankruptcy and foreclosure. Investors that find the optimal balance between debt and equity financing are best suited to sustain drops in their portfolio's performance.

Tighter loan requirements

Banks' tighter loan requirements are here to stay. You may have trouble if a property's loan will become due or needs to be renewed — or you simply want to refinance it to take advantage of better terms. Loans are based on fair market value (FMV) and, if your property is appraised for less than you expect, you might not qualify for sufficient funds, especially if your bank has tightened its loan-to-value (LTV) requirements.

Even if you're not looking to refinance, you may find that some distressed properties are in violation of their LTV or debt coverage ratios, especially if their net operating income has declined substantially. If so, an uncooperative bank may decide to foreclose or call the loan.

Stress test

Small differences in personal circumstances and preferences can lead to vastly different investing choices — there's no "right amount" of leverage to use. But while each investor may have a different situation and risk tolerance, there are limits to the amount of leverage that should be applied. Investors who wish to maximize profits through leverage shouldn't repeat mistakes from the past.

One method for determining an appropriate leverage is to apply a "stress test" to cash flow projections for a property. Change key variables one by one and evaluate how each change affects cash flow. For example, what would happen if your vacancy rate jumped to two or three times its normal level? What would happen if you had to lower the rental rate or make significant concessions just to attract new tenants?

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Also prepare best-, worst- and most-probable-case scenarios for each investment. Would the property still have sufficient positive cash flow to cover a worst-case scenario for a year? If not, would you have enough cash in the bank to survive?

Think it through

The fact that a bank won't approve a traditional loan for your latest investment may be merely the result of today's more conservative banking environment. On the other hand, it could also be a "red flag." If the only type of financing available to you is "exotic" or "extremely creative," it may be time to reconsider whether you might be overleveraged.

The safest strategy is to never leverage a property beyond the cash flow breakeven point of your worst-case scenarios. In other words, plan your investments so that, even if rents and occupancy rates are down, cash flow will cover the property expenses — including debt and a reserve for major repairs, but excluding depreciation. This way, you won't have to dip into cash reserves to meet the operating expenses of an investment that's teetering on the brink of negative cash flow.

A traditional rule of thumb for accepted LTV ratios among banks and private equity funds is 70% to 80%. But no one says you have to take on the maximum amount of debt your lender is willing to offer. Today, many investors take a more conservative approach, borrowing only 60% to 65% of their property's appraised value. Such a ratio will provide you with the advantages of leverage without putting cash flow or reserves at excessive risk, and thereby making the quest to achieve financing less difficult.

Find a happy medium

Leveraging is a balancing act — you don't want to overleverage and put yourself at undue risk, but you also don't want to underleverage and miss out on strategic investment advantages. To find your happy medium, work with your financial advisor.

ASK THE ADVISOR

Can capitalization rate issues affect my property valuation?

Capitalization rates are a critical component when real estate investors are comparing different investment opportunities. Unfortunately, cap rates are often misunderstood and improperly derived, which can affect the accuracy of a property valuation.

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Cap rates in a nutshell

A property's capitalization rate represents its rate of return, based on the expected income generated by the property. It's used to estimate the potential return on an investment and quantify the risk related to actually attaining that return. The cap rate is calculated by dividing the expected income (after fixed and variable costs, not including debt costs), or net operating income (NOI), by the total value of the property.

The impact on valuation

The interrelationship of NOI, cap rate and property value means that a property's value can be determined using the NOI and the cap rate — property value equals the NOI divided by the cap rate. A higher cap rate will therefore result in a lower property value, NOI being equal. Obviously, then, application of a cap rate that is too high to the subject property will result in an underestimate of the property's value, and vice versa.

Disputes over the proper cap rate to use when valuing a property can stem from different approaches to developing a cap rate from comparable properties, particularly when calculating the properties' NOI. For example, if one party takes account of management company fees in computing the NOI, and the other doesn't, they will arrive at different cap rates. Excluding the fees produces a higher rate that reflects the increased risk from the lack of professional management. The inclusion or exclusion of replacement reserves in the NOI calculation can likewise affect a comparable property's cap rate.

Discrepancies can also arise if one party derives the cap rate from data on comparable properties using historical income. Developing a cap rate from historical data and then applying it to the subject property's year-1 income projections will overvalue the property because projected income is riskier than historical income. Instead, the cap rate should be based on comparable properties' pro forma projections, which will have risk similar to that of the year-1 projections.

Beyond the numbers

No single approach for calculating cap rates exists — income and expense projections are treated differently by different parties and for different purposes. With the cap rate having such a significant effect on a property's value, it's vital that you ensure an appropriate cap rate is employed for your valuation.

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IT ALL ADDS UP - PARTNER PROFILE

Michael W. Hurwitz, CPA, MST

Michael W. Hurwitz is a partner with the firm's Real Estate Group. To his role, he brings more than 25 years of experience and a versatile set of skills acquired in his time working with public and private companies in the real estate sector. He is based in Marks Paneth's midtown Manhattan headquarters.

While considered the firm's real estate investment trust (REIT) specialist, Michael's industry knowledge spans a vast number of additional areas including real estate tax issues, opportunity funds, portfolio restructurings, acquisitions and dispositions, partnership taxation and core tax compliance matters.

In addition to his professional activities, Michael is an adjunct professor at New York University's Schack Institute of Real Estate and is an avid Buffalo Bills' fan, weekend golfer and chess enthusiast.

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For Further Information

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