MARKS PANETH

ACCOUNTANTS & ADVISORS

REAL ESTATE ADVISOR - SEPTEMBER, 2015

THE IRS IS WATCHING REAL ESTATE DONATIONS TO CHARITY

Donating real property to a charity can both further your philanthropic goals and provide valuable tax deductions. But the IRS imposes strict rules on charitable deductions that you must follow if you want to reap the tax savings you expect.

Qualified Appraisals

The IRS generally requires taxpayers to obtain a qualified appraisal for charitable deductions that exceed $5,000. You also must complete Form 8283, Section B, and attach it to your tax return. If you claim a deduction of more than $500,000, you also must attach the appraisal to your tax return.

For real estate, the appraisal must contain a complete description of the property. While "complete description" isn't specifically defined, the IRS provides guidance that the description may include certain items. For instance, a complete description may include such details as street address, legal description, lot and block number, physical features, condition, dimensions, zoning and permitted uses, the property's actual use, and its potential use for other higher and better uses.

The appraisal also must include:

The donation date,
Terms of any agreement entered into by or on behalf of the donor that relates to the use, sale or other disposition of the property
The name, address and taxpayer identification number of the qualified appraiser (see the sidebar "Who's a 'qualified appraiser'?") and, if applicable, the same information for the person or partnership that employs the appraiser
The appraiser's qualifications, including background, experience, and memberships in professional appraisal associations
A statement that the appraisal was prepared for income tax purposes
The date(s) the property was valued
The appraised fair market value (FMV) on the date of donation,
The method of valuation used to determine FMV
The specific basis for the valuation, such as any specific comparable sales transaction.

The appraisal itself must have been performed not earlier than 60 days preceding the date of donation. And, you must receive the appraisal report before the due date, including extensions, of the tax return on which the deduction is first claimed. If you're first claiming the deduction on an amended return, you must receive the appraisal before the date the amended return is filed.

Valuation Methods

An appraisal may require the combined use of two, or even all three, of the following valuation methods:

Comparable sales. This method compares the donated property with similar properties that have been sold. The sale prices — after adjustments for differences in date of sale, size, condition, location and other factors — determines the estimated FMV of the donated property.

For each comparable sale, an appraisal must include the buyer's and seller's names, deed book and page number, date of sale, selling price, property description, amounts and terms of mortgages, property surveys, assessed value, and tax rate, along with the tax assessor's appraised FMV. The appraiser should also document each item of adjustment.

Capitalization of income. The income method capitalizes the property's net income at a rate that represents a fair return on the particular investment at a particular time, considering the risks involved, such as a lack of creditworthy tenants with long-term leases in place.

Replacement cost. This method isn't typically used alone to determine FMV — it's instead used to support the value reached using other methods. Replacement cost is calculated by considering the cost of materials, quality of workmanship and number of square feet in the building. Consideration is also given to physical deterioration, functional obsolescence and economic obsolescence. When this method is applied to improved real property, the land and improvements are valued separately.

Importance of Accuracy

Don't underestimate the importance of an accurate appraisal. If the value is understated, you'll miss out on your full tax-saving opportunity.

If the value is overstated and this causes you to underpay your tax by more than $5,000, you could be liable for a penalty on the resulting underpayment. A 20% penalty applies if the value or adjusted basis claimed is 150% or more of the correct amount. A 40% penalty applies if the value or adjusted basis claimed is 200% or more of the correct amount.

Tread Carefully

A charitable donation of real property can provide a significant tax deduction. Work with your tax advisor to ensure you don't make any missteps that could unnecessarily reduce or eliminate your deduction or subject you to underpayment penalties. You should also perform due diligence on the charitable organization that you are donating the property to in order to ensure that it is a recognized, charitable organization which will allow you to take an income tax deduction on your tax return.

FOR THE 6TH YEAR, MARKS PANETH RECOGNIZED AS A TOP 3 PROVIDER OF FORENSIC ACCOUNTING SERVICES

Marks Paneth LLP has been ranked among the top three providers of forensic accounting services in the New York metropolitan area by readers of the *New York Law Journal* (*NYLJ*). Marks Paneth is the only firm to be voted among the top three in this category for all six years since the NYLJ's 2010 inaugural survey.

Read more here.

WHO'S A "QUALIFIED APPRAISER"?

A qualified appraisal must be made, signed and dated by a qualified appraiser who has either 1) earned an appraisal designation from a recognized professional appraisal organization or 2) met certain minimum education and experience requirements. For real property, the appraiser must be licensed or certified for the type of property being appraised in the state where the property is located.

In addition, the appraiser must:

- Regularly prepare appraisals for which he or she is paid.
- Demonstrate verifiable education and experience in valuing the type of property being appraised.
- Not have been prohibited from practicing before the IRS at any time during the three-year period ending on the date of the appraisal.

Finally, a qualified appraiser may not receive fees based on a percentage of the appraised value.

MICHAEL HURWITZ FEATURED IN *MARKETPLACE BUSINESS*

Partner Michael Hurwitz was recently featured in a Marketplace Morning Report broadcast titled "Darden restaurants went through a lot in one year," in which he describes a major benefit of spinning real estate holdings into REITs (real estate investment trusts).

Read more: *Marketplace Business*

TRIPLE NET LEASE INVESTMENTS

Due Diligence is Key

Properties with triple net leases offer investors several advantages, but the primary one is the opportunity to receive a steady stream of income with minimal management responsibilities for the property. This is because the tenant is responsible for paying real estate taxes, insurance, property maintenance and other operating expenses.

Every triple net property is different, however and thorough due diligence is essential before investing. Several areas in particular call for close examination.

Tenant Quality

Bad tenants can cause problems for most types of real estate investments. But triple net leases are especially vulnerable because they typically involve only one larger tenant. If the tenant defaults, the property's revenue stream ceases altogether.

The first step in evaluating tenant quality typically involves looking at the tenant's credit rating with Standard & Poor's, Moody's or Fitch. Bear in mind, though, that properties with tenants boasting the highest credit ratings usually offer investors the lowest returns because they expect more favorable rental rates and terms. Conversely, properties with lower-rated tenants are at a higher risk, although they offer the possibility of greater returns to compensate for risk.

Also look at tenants' financial statements and income tax returns to determine, for example, the amount of cash on hand, future liabilities, debt levels and revenue stability. Additional research should be done regarding the ongoing viability of the tenant's business. For instance, could it be threatened by obsolescence, increased competition or regulation?

Consider, too, the type of tenant. A local or regional store (as opposed to a national store) may be riskier because it will likely have a shorter lease term and limited cash reserves and financial backing.

Property Condition

Before investing, you'll need up-to-date information on the property's condition, age and improvements. If the property has improvements, are they special-use and designed specifically for the current tenant, or could they be used by other tenants in the future with little conversion cost and work required? Has the current tenant invested a significant amount of expense and effort in making improvements? If so, the tenant is more likely to renew its lease.

In addition to conducting a property inspection, obtain valuations of the land, building and improvements. It's possible that the property has little value without a tenant.

Property Location

As with most real estate investments, don't overlook location. You shouldn't take for granted that the tenant that sought out a neighborhood years ago is still satisfied with the area. Does the location continue to provide sufficient demand for the tenant's products or services? If it's a retail business, how is the retail traffic? If the tenant is part of a national company, how is that location performing compared with other locations? Among other things, due diligence requires a look at the area's employment rate, median income and population density.

If the tenant might not renew, zoning also can come into play. For example, will zoning regulations make it difficult to get a new tenant into the space? And if a new tenant is necessary, what are the market expectations in the area regarding landlord and tenant responsibilities? It's possible the market might not bear the current leasing arrangements, cutting into investors' profits.

Last But Not Least

Not every property advertised as "triple net" truly qualifies. For example, according to the fine print of the lease agreement, a landlord may be responsible for things like snow removal, roof maintenance and replacement, or parking lot resurfacing. So, always obtain and scrutinize the lease contract itself.

If you are considering purchase a triple net lease property, due your due diligence and feel free to contact your Marks Paneth advisor if you need assistance. Our revenue maximization and lease audit services team could help you determine if the investment is appropriate for you and help you monetize the existing lease to its maximum potential.

PARTNER PROFILE: VIVIAN MARTINEZ, CPA

With nearly 20 years of experience serving the real estate industry, Vivian Martinez, CPA, advises her clients on all facets of accounting and tax matters. To her role, she brings deep industry knowledge with a keen specialization in commercial and residential real estate as well as co-ops and low-income housing units. Vivian is committed to the real estate industry and serves as a member of the Long Island Real Estate Group (LIREG), the Association of Women Accountants in Real Estate, Asian Real Estate Professionals Association. In addition, she is a member of the New York State Society of Certified Public Accountants' Nassau County chapter – where she co-chairs the Real Estate Committee and serves as a member of the Executive Board. She is based in Marks Paneth's midtown Manhattan headquarters.
As an advocate of travel for educational enrichment, Vivian enjoys immersing herself in different cultures and learning about them.

SWAP AGREEMENTS

Mitigating the Risk of Rising Interest Rates

For owners and investors, rising interest rates present a very real risk. Interest rate swap agreements can help mitigate this risk. One key benefit of swaps is flexibility — they can be custom-made to fit the parties' specific financing needs. If handled properly, such arrangements can benefit all parties.

Ups and Downs

An interest rate swap agreement is a type of derivative contract — independent of the underlying loan — that can be used to manage the risk of interest rate fluctuations and convert a borrower's exposure from a variable rate to a fixed rate.

The most common type of interest rate swap is known as the "plain vanilla" swap. Here, a party (usually the lender) with fixed-rate liabilities agrees to "swap" interest payments with a party (the borrower) with variable-rate liabilities, such as a mortgage. Effectively, the lender agrees to make the borrower's variable interest payments over a given period. In exchange, the borrower agrees to pay a fixed interest rate on the same "notional" amount.

The swap's fixed rate equals the present value of expected future variable rates, customarily based on London Interbank Offered Rate (LIBOR) futures. The accuracy of this prediction determines whether the lender gains or loses money. The borrower usually pays no other incremental fees associated with the interest rate swap, and principal payments aren't affected by interest rate swaps.

Typically, one party pays out each month (or quarter) for the difference between the variable and fixed rates. If the variable rate ends up rising above the fixed rate, the lender pays the borrower the difference.

Conversely, if the variable rate falls below the fixed rate, the borrower pays the lender the difference. Should the rates stay constant, neither party pays. When payments under the agreement are combined with the variable rate, the net amount paid by the borrower equals the fixed interest rate specified in the agreement.

For example, assume you have a variable rate loan with a current interest rate of 5% and you enter into an interest rate swap with your lender for a fixed rate of 5%. If the floating interest rate falls to 4%, the rate on your loan also drops to 4%; however, under the swap, you must pay the lender 1% interest to account for the difference between the variable rate of 4% and the swap rate of 5%.

The result: You still end up paying a total of 5% interest. But if the floating rate climbs to 6%, thereby increasing your loan rate to 6%, the lender must pay you the 1% difference, effectively leaving your rate at 5%.

Coverage Against Losses

Lenders may require borrowers to secure their swap obligations with a mortgage subject to a title insurance policy. But such insurance typically excludes losses sustained by the insured lender as the result of a court ruling that the mortgage is invalid or unenforceable because the mortgage allows for interest rate changes. For that reason, title insurance policies associated with swap arrangements require endorsements (and additional premiums) that provide the lender coverage against such losses.

A *direct obligation endorsement* provides coverage to the lender if the insured mortgage is invalid or unenforceable or lacks priority as security for the repayment of the swap obligation. An *additional interest endorsement* provides coverage if the insured mortgage is invalid or unenforceable or lacks priority as security for repayment of the "additional interest."

Both endorsements typically don't cover changes to the swap agreement after the date of endorsement. Moreover, the stay, rejection or avoidance of the insured mortgage or any other remedy ordered by a court under bankruptcy or similar creditors' rights laws, isn't covered.

In addition, the calculation by a court of the amount of the borrower's swap obligation or additional interest isn't covered. And last, but not least, the endorsements don't cover the invalidity, unenforceability or lack of priority of the insured mortgage due to the failure to pay all applicable mortgage recording taxes, where applicable. This last exclusion would apply only in states where the government assesses a mortgage tax based on the loan amount.

Do Your Homework

If you're concerned about fluctuating interest rates, bring in your financial professional.

ASK THE ADVISOR

How Should Rent Escalation Clauses Address CPI?

Rent escalation clauses are a common part of commercial property leases. One popular method for calculating the escalation amount bases the rent increase on changes in the consumer price index (CPI). The CPI approach isn't as straightforward as it might seem, though.

CPI in a Nutshell

The CPI is a measure of the average change over time in the prices paid by urban consumers for a "market basket" of consumer goods and services. The market basket is developed from detailed spending information provided by families and individuals. Spending items are classified into more than 200 categories arranged into eight major groups, including food and beverages, housing, apparel and transportation.

The Vagueness Risk

The CPI is published by the US Bureau of Labor Statistics (BLS), which cautions that many escalation clauses tied to the CPI are vague. That's because the BLS publishes thousands of CPIs every month. To combat this risk, escalation clauses should specifically address which CPI will be used:

The population group. The BLS publishes price changes for two population groups — the All Urban Consumers (CPI-U) and the more narrow Urban Wage Earners and Clerical Workers (CPI-W). According to the BLS, the CPI-U is the broadest measure of consumer inflation it produces and is typically subject to less sampling error than the CPI-W.

The item category. The BLS encourages users to specify a broad item category, such as the all-items index, when writing an escalation clause. Why? Because such categories are typically subject to less sampling error.

The geographic area. The BLS publishes indexes for US City Average (or national) level, regional level (for example, the West region) and some local metropolitan areas (for example, Atlanta). The US City Average indexes have larger sample sizes than those for metropolitan areas. So, again, there will likely be less sampling error.

Seasonal adjustments. Some CPIs are published on a seasonally adjusted basis to eliminate the effect of price changes caused by recurring seasonal changes (for example, because of weather or holidays); these indexes are subject to annual revision. The BLS advises against using these CPIs in escalation clauses.

Other Considerations

In addition to being clear about the CPI that will be used for rent escalation, specify in the lease the base rent amount that's subject to escalation (that is, the initial rent), the timing and frequency of adjustments. Also, consider including a rent floor to ensure a minimum increase regardless of the change in CPI.

LEVERAGE OUR EXPERTISE

Marks Paneth LLP has served the real estate industry for more than 100 years. We assist many of the industry's premier commercial and residential real estate owners, developers, builders, REITs (real estate investment trusts) and property managers. With more than 100 professionals, including 15 partners and principals, who focus on the real estate industry, we bring deep expertise to every engagement.

For Further Information

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

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