

Real Estate *advisor*

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Beyond the NOI-based appraisal

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methods can lead to
smarter investments**

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your firm with a succession plan

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Beyond the NOI-based appraisal

Sophisticated valuation methods can lead to smarter investments

One of the simplest and most common methods of establishing real estate value involves taking one year's net operating income (NOI) and dividing it by an appropriate capitalization rate to determine the sales price or property value. But questions regarding the accuracy of NOI numbers can make this a less than reliable method of valuation.

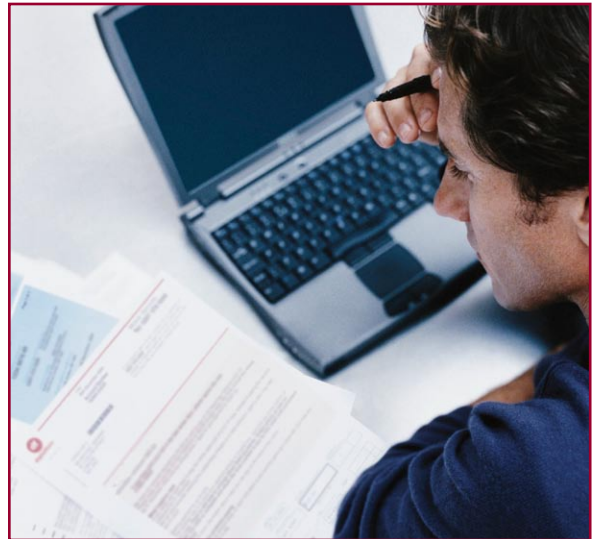
Buyer beware

Unfortunately for unwitting buyers, the NOI that sellers provide isn't always reliable. Sellers often prefer to price their property based on 12 months of NOI. However, they may skew those numbers by operating properties in a "soon-to-be-sold" mode in the year before the sale.

Smart investors can counter these manipulations by not relying on numbers that can't be independently verified.

For example, sellers may artificially inflate property income by billing in advance, billing based on inflated estimates and collecting lump sum payments. Classifying operating expenses as capital items is another favorite ploy. The end goal of such maneuvers is to inflate NOI, and with it, property value.

Smart investors can counter these manipulations by not relying on numbers that can't be independently verified. A zero-based budget with numbers developed by the investor is a helpful tool.



Additionally, it's wise to analyze values generated by more sophisticated analytical tools, such as:

Net present value (NPV). NOI-based appraisal methods capitalize a single year of earnings. Alternatively, investors can calculate the net present value (NPV) of long-term cash flow projections. The NPV method is often used for rehab projects or properties under construction, because it allows annual cash flows to fluctuate until the investment generates a more predictable income stream. At the end of the projection period — typically three to seven years — appraisers calculate a terminal (or residual) value by capitalizing the expected cash flows in the final projection period.

The NPV method takes annual projected cash flows for a proposed investment property and then determines each year's present value by applying a discount rate. NPV equals the sum of these present values, including the present value of the terminal value.

The appropriate discount rate for real estate investors generally takes into account the opportunity cost, or the rate of return the investor can earn on an investment that's comparable in size, risk and duration.

A positive NPV indicates that the investment has good potential or a safety factor against future shortfalls. A negative NPV indicates the property may fall short of the target yield and the investor needs to withdraw or lower the offer, find a way to increase cash flow, or accept a lower rate of return.

Internal rate of return (IRR). The IRR is one of the most popular methods for evaluating and comparing investment returns. It's useful for comparing real estate opportunities with alternative investment options. Closely related to NPV, the IRR is the interest rate at which the NPV for an investment is equal to zero.

Knowledge is power

Successful investors understand that, if they don't do the homework necessary to determine the best price, they'll almost always overpay. As an investor, your goal is to be aware of the maximum price you can pay and still receive a solid rate of return in light of the associated risks. With a top dollar firmly in mind, you can negotiate with confidence for the lowest possible price. Although sellers occasionally make a mistake by dramatically underestimating the market value of real estate, properties offered for sale are much more likely to be overpriced than underpriced.

It's up to you, the investor, to establish the most accurate value for the property you're considering. Using the sophisticated analytical tools described above and understanding the numbers generated are two of the most important steps you can take in this direction. ■

Help ensure a successful future for your firm with a succession plan

All too often business owners get so bogged down in the daily grind of running their companies that they fail to adequately plan for their futures. But not planning for the inevitable can place your real estate business on the endangered species list and significantly affect your financial future. One of the best things you can do now to help ensure a successful future for your company is to develop a succession plan.

A well-thought-out succession plan will help you pass on responsibility for running the company to a successor, transfer ownership and extract

your money. Let's review some of the decisions you'll need to make and the criteria to consider when setting up your succession plan.

Keeping it in the family

You'll first need to ask whether you plan to transfer the business to a family member or someone else inside the company, or sell it. If your children are involved in the business or there's another logical successor — someone who, with a few additional skills, could fill the seat behind your desk — you should start grooming that person as early as possible. Depending on the amount of support and knowledge your prospective

replacement needs, this may take several years or just a few months.

Because business succession and estate planning are generally linked, make sure you consult legal and financial advisors to help you create the transfer plan, fund your retirement, and build an estate plan that equitably divides your wealth among family members who participate in the business and those who don't.

If you can find the right outside buyer, you may be able to sell your business at a premium.

Setting the price

If none of your family members are qualified or want to assume the mantle, consider:

- Selling the firm to your employees through an employee stock ownership plan (ESOP),
- Setting up a management buyout, or
- Selling to an outside buyer.

Each of these options has its pros and cons. The first two options save you the time and expense involved in finding an outside buyer. On the other hand, if you can find the *right* outside buyer, you may be able to sell your business at a premium.

To do so, you'll need to start preparing. Begin by upgrading your business processes, with special emphasis on financial management and reporting. A well-run, efficient business will command the highest price.

Next, determine the market value of your business. This may require the expertise of a professional who

specializes in business valuations. Your valuation expert will assess your business's tangible and intangible assets and project future revenue. Valuation professionals can help you decide whether it makes sense to sell your business intact or sell individual assets piecemeal.

Off to market

When you're ready to put your business on the market, develop a list of possible buyers, such as your competitors and business associates. Once you've identified a few buyers, formulate a plan for marketing your business to these groups.

You can personally approach potential buyers with whom you have an established relationship — for example, partners, business associates and employees — but you probably should enlist the assistance of merger and acquisition specialists such as business brokers and investment bankers to act as a go-between with other types of buyers. These advisors can guide you through the often lengthy and complicated sale process.

Consider the tax costs

Although you may think that, once you've chosen a successor or found a buyer, you're home free, think again. Make sure you meet with your CPA to discuss the tax consequences of the transfer or sale, which can have a major impact on the transaction's success or failure. ■



Not quite a “gift”

The tax 411 on COD

As the fallout from the financial tremors of 2008 continues, many real estate owners are engaging in transactions involving the cancellation of debt (COD). Although COD can be complicated enough with only the borrower and lender involved, Uncle Sam’s demands for a take can make things even more taxing.

Basic COD rules

From a tax perspective, cancellation or forgiveness of debt isn’t quite as much of a “gift” as it might first appear, because it results in ordinary taxable income to the debtor. COD transactions can result from foreclosures, cash settlements, loan workouts, related-party acquisitions of debt or debt-for-equity swaps.

Let’s look at an example: An investor owns an office building that cost \$10 million. The building, which is subject to \$8 million of secured debt, has a current fair market value of \$6 million. If the lender agrees to a loan payoff of \$6 million instead of \$8 million, the debtor will have \$2 million of ordinary taxable income (in the absence of exceptions).

For partnerships, the \$2 million of COD income would be recognized on the last day of the partnership’s taxable year and passed through to partners as taxable income.

Foreclosure or deed-in-lieu

A foreclosure or deed-in-lieu of foreclosure, where the borrower conveys all interest in a property to the lender to satisfy the loan, is treated for tax purposes as a sale of property to the lender.

If the debt involved is *nonrecourse* debt, the gain or loss on the sale will be the difference between the amount of debt and the seller’s basis in the property. Such sales aren’t, however, considered



COD and don’t qualify for certain exclusions from taxation.

If the debt is *recourse* debt, the sales price for tax purposes will be the lower of the fair market value (FMV) of the property or the outstanding secured debt balance, and the gain or loss will be determined using this sales price less the debtor’s basis in the property. The debtor will then have COD income to the extent that the outstanding debt balance exceeds the FMV of the property.

Debt modification

Significant modification to the debt also may result in COD income for the debtor. For tax purposes, a significant modification occurs if the

rights and obligations of the debt instrument have been altered in material ways.

Events that automatically trigger this rule include a material change in yield (more than the greater of 25 basis points or 5% of annual yield), material deferral of payments, or principal reduction, which is treated as a reduction of yield for this purpose. Changing from recourse to nonrecourse debt, a change in debtors, or alterations in collateral or payment expectation also could trigger this rule.

Deterioration in the financial condition of the debtor doesn't qualify as a modification, nor does adding or modifying financial covenants or changes resulting from the exercise of unilateral options in debt agreements.

Related-party acquisition of debt

If a related party acquires debt from an unrelated party (that is, the debt purchaser is related to the debtor) at a discount, the debtor will generally have COD income. In such a transaction, the debtor is deemed to reissue the debt with an issue price equal to the purchase price paid

by the related party. The difference between the new issue price and the face amount of the debt will be the original issue discount, which must be amortized as income to the investor and expense to the debtor.

If a related party acquires debt from an unrelated party at a discount, the debtor will generally have COD income.

Partnership debt for equity swaps

The exchange of debt on a property for corporate stock will result in COD income if the FMV of the stock is less than the amount of the debt. This result can be avoided if the lender cancels the debt in exchange for an equal amount of capital in the corporation and has sufficient basis in the debt.

The exchange of debt for an interest in a partnership also will result in COD. In this case, COD income is equal to the difference between the debt and the FMV of the partnership interest. Even if a substantial amount of debt remains in place, the admission of a creditor into the partnership may convert debt to "partner nonrecourse debt." Such debt will be allocated to the creditor/partner, resulting in a deemed distribution to the other partners.

Work with a pro

Due to the technical nature of debt cancellation, there may be other rules and exceptions not addressed here. To help ensure that your next investment doesn't result in unexpected tax liability or land you in hot water with the IRS, please consult your financial advisor. ■

Exceptions to COD income recognition

Exceptions to the immediate recognition of cancellation of debt (COD) income by real estate investors and other debtors include:

Bankruptcy. COD realized in bankruptcy is excluded from income.

Insolvency. COD realized by an insolvent debtor is excluded to the extent of insolvency.

Qualified real property business indebtedness (QRPBI). For QRPBI incurred in connection with trade or business real estate, the debtor can elect to reduce the basis of depreciable property instead of recognizing COD, thereby reducing future depreciation deductions; the reduction will be recaptured as ordinary income.

American Recovery and Reinvestment Act of 2009 (ARRA) Section 108(i). COD realized in 2009 and 2010 may be deferred until 2014, at which time COD is recognized at the rate of 20% for five years.

Ask the Advisor

What cost-effective steps can I take to turn my rental homes “green”?

Remodeling an older rental home to make it “green” is a wise alternative to building a new property. Because of the tremendous savings in lumber, that choice alone is one of the greenest ones a landlord can make. But there are other ways to green up an otherwise energy-inefficient house.

For starters

Begin by installing natural insulation in the walls, attic and roof. Natural insulation, which has fewer potentially allergenic chemical ingredients than synthetic insulation, is highly effective in reducing heat loss and carbon dioxide emissions while maintaining a low environmental impact.

Improving roof insulation can save as much as 13% each year on heating bills, according to architect and green building expert Eric Corey Freed, author of *Green Building & Remodeling for Dummies*. Installing a well-insulated and energy-efficient water heater and energy-efficient windows also can produce significant cost savings.

Low-flow shower heads and dual-flush toilets can substantially reduce a home’s water usage. Installing energy-efficient appliances should also be a top priority.

Go solar

The average home solar heating system can pay for itself over time by saving landlords hundreds of dollars annually on their energy bills. A number of utility companies offer rebates on solar systems that can help defray the costs of installation. Some will even buy back excess energy that’s generated by a solar system. Solar water heaters are another environmentally friendly investment that can help slash energy costs.

Another way to harness the sun and save on electricity costs is with sun tunnels. These mini



skylights bring in natural light while minimizing energy loss.

Heating and cooling with less

Although an energy-efficient heating system is a must for any “green” house, it’s only the beginning. According to Freed, installing a programmable thermostat can save another 5% to 15% on heating costs.

An attic or whole house fan can bring in much-needed cooler outside air at night. This increased air circulation, which protects against mold and mildew by reducing humidity in the attic, can save up to 30% on air-conditioning costs, according to Freed.

Make the most of tax breaks

Ask your tax advisor about how the Residential Energy Property Credit, established under the American Recovery and Reinvestment Act of 2009, can help save tax dollars when greening your rental homes. Depending on a taxpayer’s adjusted gross income, this law provides a tax credit equal to 30% of the cost of all qualifying improvements, up to a maximum credit of \$1,500 for improvements placed in service in 2009 and 2010. ■



In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Practice helps keep your business grounded.

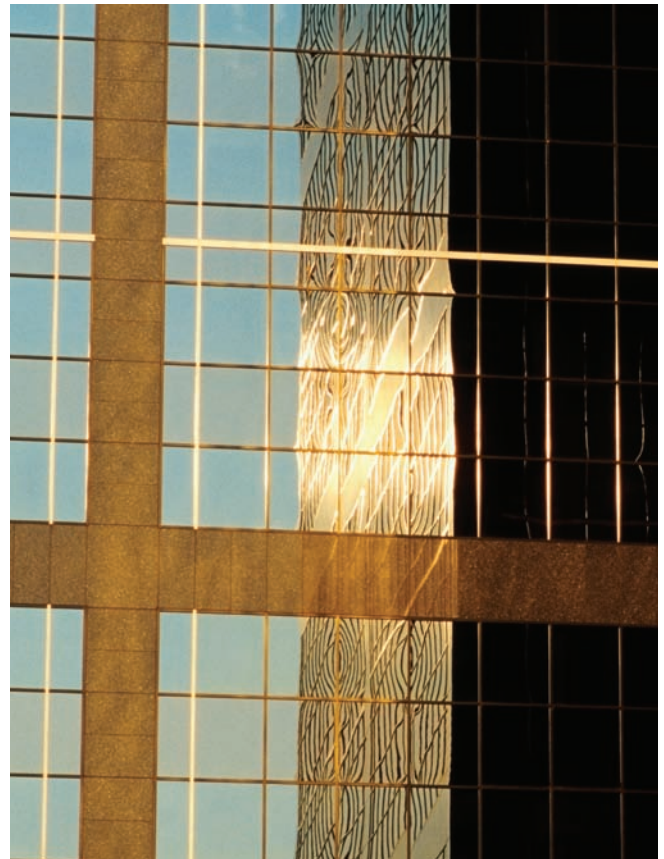
Our team puts its deep industry knowledge and experience to work for you with customized solutions based on your specific situation and requirements. With our network of locations throughout the Southeast we deliver personalized service wherever your business lands.

ACCOUNTING SERVICES:

Our team reviews your historical financial statements, evaluates trends, and pinpoints strengths and weaknesses in your financial and operational business performance. We make certain you're receiving the right kind of financial information to run your business and ensure tax compliance. We provide not only traditional credit, review compilation, and tax preparation services but also forecasts, projections and acquisition evaluation and accounting.

BUSINESS ADVISORY SERVICES:

Our Real Estate Practice helps you consider and structure various alternatives to maximize return on investment. A sampling of our services include: 1031 exchange consulting, cost segregation studies, revenue recognition and cost allocation techniques, tax credits, and business entity planning and organization choice.



With offices located throughout the Southeast, members of the Elliott Davis Real Estate Practice can respond quickly to their clients' needs. Please contact us at 1-877-340-6802 to tell us your real estate goals and learn how we can help you achieve those goals, or visit us online at www.elliottdavis.com for more information.