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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. 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.

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 re-

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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. 

sults 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.

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.

(continued on back)

The Tax 411 on COD (continued)

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.

Our Real Estate Practice

Our *Real Estate Practice* is headed by Marilyn Millare, a senior partner with the firm. She has served real estate clients, including Arnel & Affiliates, for over 25 years.

Marilyn joined **HMWC CPAs & Business Advisors** in 1977, where she became a partner in 1985. Her professional memberships include the American Institute of CPAs and the California Society of CPAs. Marilyn's areas of expertise include real estate transactions, tax planning, and pension and cafeteria plan administration.

For more than 35 years, **HMWC CPAs & Business Advisors** has been consulting with real estate professionals on a wide variety of issues. Our Real Estate group is comprised of highly experienced accountants, real estate consultants, management

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.

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. 

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- ◆ *Development*
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With this experience, **HMWC CPAs & Business Advisors** is uniquely positioned to serve the real estate industry and to understand its continually changing environment.



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