

*Mr. Van Vleet's response to question  
on tax-affecting leasehold interest:*

It would be unusual to appraise the value a leasehold interest using a U.S. Treasury Bond rate. I am not a real estate appraiser; however, the real property reports that I have seen typically use real property cap rates or present value discount rates. These rates are typically calculated by dividing net operating income (which does not include income taxes) by the transaction price of the subject property. Consequently, there is typically no income tax related difference between a real estate cap rate or PV rate and net operating income (NOI). Therefore, if a real estate cap rate or PV rate is being used to capitalize NOI, there is no need to tax-affect the NOI.

In this case, the question apparently relates to capitalizing NOI using a U.S. Treasury Bond rate. I believe that income from U.S. Treasury securities is subject to federal income tax rates on interest income but is exempt from state and local income taxes. To answer this question, I will assume away that: (1) U.S. Treasury rates may not be relevant to the analysis because a lease is not backed by the full faith and credit of the U.S. government; and (2) exemption from state and local income taxes complicates the analysis. On this basis, the NOI from the lease should not be tax-affected. The effective yield of a U.S. Treasury security inherently contemplates, but is not reported net of, personal income taxes. In other words, if a U.S. Treasury security is trading at \$100 with a coupon payment of \$10, the effective yield would be 10 percent. If we take personal income taxes into account at a 50 percent rate, the effective yield would be 5 percent ( $(\$10 \times (1 - 0.5))/\$100$ ). Consequently, if you are going to use the U.S. Treasury effective yield rate, I would recommend using a pre-personal tax measurement of income such as NOI. This answer assumes that investors in both the lease and the U.S. Treasury security are taxed on the same basis, which they are not due to the differences in state and local income tax treatment.

A cautionary note: I would be very careful about the valuation of a lease in the healthcare industry. These types of issues often raise the issue of private benefit and inurement. An improper treatment of a lease valuation could endanger the 501(C)3 status of one or more of the entities.

Hope this helps.

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