DEBT

LEVERAGE

Leverage means using borrowed funds to amplify the outcome of equity investment; the greater the ratio of borrowed funds to equity, the greater the degree of financial leverage employed.

Leverage is favorable so long as the rate of return on assets (i.e., overall rate of return, return on cost, cap rate) exceeds the cost of borrowing.

Leverage is unfavorable when the cost of borrowing exceeds the rate of return on assets.

The “spread” is the difference between the rate of return on assets and the cost of borrowing. Even a small favorable spread greatly magnifies return on equity on a highly leveraged investment, however, a small negative spread (unfavorable leverage) on such a project can result in a negative rate of return to the equity position.

So long as the debt service constant (annual debt service divided by the amount borrowed) is less than the rate of return on total assets, additional financial leverage increases cash flow to the equity position.

In addition to amplifying returns, there are income tax benefits to using leverage:

- Federal income tax benefits
- Interest payments are tax deductible
- Depreciation of buildings and other improvements (investment property) is tax deductible, even when they are purchased with borrowed money
- When property increases in value, or decreases by less than the amount of the accumulated depreciation allowance, there is a gain on disposal; the gain (capital gain) is generally afforded favorable income tax treatment under capital gains tax rules
- Using borrowed money enables investors to control more property and thereby reap greater capital gains

Measuring leverage

Leverage can be measured as the relationship between equity investment and total market value of assets acquired;

Corporate financial analysts frequently express this relationship as a debt/equity ratio, the ratio between borrowed funds and equity funds.

The convention in real estate investment is to use a Loan-to-Value ratio:

\[ \text{LTV} = \frac{\text{debt}}{\text{value}} \]

The LTV provides mortgage lenders with a tool for estimating a margin of safety. Should borrowers default on their obligation to repay a mortgage loan, the lender expects to recoup from the proceeds of a sale of the mortgaged property; Expressing loans as a percentage of the value of the mortgaged property provides some indication of risk of loss.

The LTV provides investors a measure of the dollar amount of real estate that can be controlled with a given amount of equity funds. Lenders generally specify the maximum permissible LTV.

Financial Risk

Financial risk is the risk that property cash flow from will be insufficient to service debt. Greater leverage increases default risk and the greater the possibility that equity investors will either have to invest additional funds or default on a mortgage note.

The debt coverage ratio is a measure of financial risk:

\[ \text{Debt coverage ratio} = \frac{\text{Net operating income}}{\text{debt service}} \]

The amount of leverage for an investment is typically determined by the financing available.
The loan amount is determined in part by the amount of NOI, frequently calculated using the lender’s minimum permissible DCR. The maximum loan amount is calculated by dividing NOI by the minimum DCR. Dividing this amount by the annual loan constant for the most likely loan terms results in an estimate of the loan the property will support.

**Exercise:** NOI is $120,000 per year. Calculate the maximum loan amount for a 25 year loan at 8% with a debt coverage ratio of 1.25.

The benefits of financial leverage can be overemphasized; As more money is borrowed to finance an investment, the venture becomes increasingly risky. Operating results are based upon expectations that may not be met; If NOI as a percent rate of return on assets, drops below the debt service constant, then using financial leverage will reduce the current return on equity. Increasing the amount of borrowed funds relative to equity funds also drives up the cost of borrowing. Amortization (payment required) Amortizing loan payment—the required periodic payment on a loan, including principal and interest repayment, that will retire the loan over a specified period.

**Types of lenders**

- **Commercial banks**
  They typically originate several times the dollar volume of commercial real estate loans as does the life insurance industry, the second most significant source. Bank regulators specify the maximum loan-to-value ratios on bank-originated mortgage loans. Because of their greater liquidity needs, banks typically favor short-term construction loans and loans to finance mortgage company loan portfolios, rather than traditional long-term, fully amortizing mortgage loans.

- **Life insurance companies**
  Their predictable cash inflows and long-term financial obligations make long term mortgage loans a good investment for them; Some prefer to concentrate on large loans to finance major real estate developments while others are willing to finance smaller properties.

- **Pension funds**
  Cash inflows and financial obligations are similar to life insurance companies’ in terms of predictability and term structure; Since the mid-1990s, they have moved aggressively into real estate lending.
  Commercial mortgage-backed securities (CMBs) have in recent years become a significant way to generate funds for mortgage lending. CMBs represent shares in a pool of mortgages; Holders of the CMBs get the cash flow from the mortgage pool, minus a loan servicing fee.
  In the past, most CMBs were issued by lenders who originated the loans or by entities that acquired ownership of the loan originating institutions. More recently, investment bankers have been forming partnerships with lenders and issuing CMBs.

**CREDIT AND SECURITY INSTRUMENTS**

- A promissory note is a written promise to pay a sum of money—the evidence of indebtedness.
- A mortgage (deed of trust) is a pledge of property as collateral for a loan; It specifies the lender’s rights to the mortgaged asset in the event of default.
- A purchase-money mortgage secures a promissory note a seller takes back in part payment of the purchase price.
- A blanket mortgage is used to pledge two or more properties as collateral for the same loan; It may contain a partial release clause that releases one or more properties from the mortgage when specified amounts have been paid on the loan.
An open-ended mortgage is written so that subsequent loans can be secured by the same mortgage. A junior mortgage (second, third, etc.) is subordinate to senior mortgages in priority of payment of the loan in the event of default. Funds generated from a foreclosure sale are used first to retire the most senior mortgage (the first mortgage), then the second most senior mortgage, and so on. The first mortgage is a senior mortgage, and all subordinate mortgages are junior mortgages.

**Credit Terms**

A fully-amortizing loan requires periodic payments (usually monthly) of principal and interest so that the principal is retired over the term of the loan. A partially amortizing loan includes some repayment of principal during the loan period with a “balloon” payment required at the end of the term. An interest only loan (straight/term/bullet) does not reduce principal during the loan but the entire principal is due and payable when the loan matures. Some loans provide that all, or a portion of the interest and/or payments are deferred. The cumulative amount (principal and accrued interest) becomes due and payable in a lump sum or in periodic payments at specified future dates. Common examples are graduated payment mortgages and reverse annuity mortgages. A fixed-rate loan has a specified interest rate charged throughout the loan term. An adjustable/variable rate loan has an interest rate that varies with some specific index, such as the yield on treasury securities. A renegotiable rate loan (rollover loan) has a fixed interest rates for a specified periods after which the rate is reset by the lender. An equity participation loan gives the lender a specified share in any increase in property value, in addition to the specified interest (equity kicker). An installment sales contract (land contract) provides that title to the property will be transferred to the buyer by the seller at a future date, when all or a specific portion of the purchase price has been paid. Sale and leaseback is a method used to free-up the capital that a property user would rather invest another way; It is a common strategy for generating development capital.

**Interest Rates**

Nominal or contract rate—the rate a borrower is contractually obligated to pay, computed on the face amount of the note. Effective rate—the rate actually paid, based on the amount of borrowed funds available to the borrower; This may differ significantly from the nominal rate when the amount of the loan proceeds is reduced due to discount points or loan origination fees. Real rate—the effective rate, adjusted for price inflation; When the inflation rate increases, the real rate of interest on outstanding, fixed-rate loans declines. After-tax borrowing costs are usually lower than the before-tax cost, because interest expense is usually deductible.

**Comparing Financing Alternatives**

Effective interest rates differ between lenders for a variety of reasons. They may quote different contract rates. Their effective rates might be different, due to differences in loan origination fees or discount points. Some lenders may not quote a definite interest rate until late in the loan approval process. Some lenders quote their rate as a fixed percentage of a benchmark number while others may lock-in a fixed rate early in the loan approval process.
INCOME TAXES
Federal income tax benefits of using leverage
- Interest payments are tax deductible
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TAX BASIS
A property's initial tax basis is the starting point in determining income tax consequences of operating the property and, ultimately, the tax consequences of disposal. During the holding period, the tax basis is adjusted to reflect disinvestment or additional capital investment. Selling or exchanging a property generates a gain or loss equal to the difference between the sales price and the adjusted basis of the property at the time of disposal.

THE INITIAL TAX BASIS
When property is purchased, the initial tax basis is the purchase price (including everything of value given in exchange plus all costs incurred in obtaining and defending title). If two or more assets (e.g., land and buildings) are acquired together, the initial basis must be allocated between them, using the ratio of their relative market values; Possibilities for determining relative values include:
- Specify the price of each in the original purchase contract; if the purchase is an arm's-length transaction, such contractual determination forms a defensible cost allocation basis
- Use the ratio of land value to building value estimated by the tax assessor, who usually assesses land and improvements separately
- Have an independent appraiser estimate the relative value of land and buildings

Adjusting the basis for cost recovery
Depreciation allowance—taxpayers are entitled to deduct from taxable income an allowance for recovery of capital invested in improvements. Depreciation allowances apply only to property held for business or investment purposes and not to property held for personal use or primarily for resale. Only improvements are depreciable. In general, the cost of improvements to real estate used in a trade or business or for production of income may be recovered over:
- 27.5 years for residential rental purposes
- 39 years for buildings intended for other allowable purposes
- 15 years for land improvements such as walks, roads, sewers, gutters and fences
Allowances for buildings are computed using the straight-line method; To determine the monthly allowance, divide the amount to be recovered by the number of months in the recovery period. The taxpayer is entitled to the allowance for the number of months the property is held for business or investment purposes. Claiming a tax deduction for cost recovery allowances reduces a property's tax basis; The lower the adjusted tax basis at the time of sale, the greater the taxable gain on disposal.

Other adjustments to the tax basis
The basis is reduced when a portion of an asset is sold or destroyed by casualties. A partial sale requires the tax basis to be reduced by the portion of the total basis properly attributable to the part sold.
In the case of casualty losses, the basis of the property must be reduced to reflect allowable loss
deductions in the year of the casualty, plus any loss for which compensation is received.
An owner’s tax basis is increased by expenditures that materially increase the property’s value or
useful life - generally, any property expenditure not deductible as a current expense.
Transaction costs (acquisition and disposition) are added to the tax basis.

**SUMMARY OF CALCULATING BASIS**

**Original Purchase Price**

+ Purchase Costs
+ Capital Improvements
- Casualty Losses
- Accumulated Depreciation
= Total Adjusted Basis

**EXAMPLES:**

Calculating interest expense
Calculating depreciation (and accumulated depreciation): An apartment building has NOI of
$100,000 and is being purchased at a 10% cap rate. Assuming that 15% of the value is attributable
to land, what is the annual depreciation allowance?
Calculating after-tax cash flow: The property is being purchased with a loan with a DCR of 1.4.
Interest expense for the year is $61,429. What is the before-tax cash flow? What is the after tax
cash flow of an investor with a 33% tax rate? A 39% tax rate?
Calculating basis/gain on sale: Closing costs on the acquisition were 3% of the price. The property
was sold for $1,389,353 at the end of 5 years. Closing costs on the sale were 6%. What is the
taxable gain on the sale? What is the capital gains tax at 20%?

**TAX CONSEQUENCES OF OWNERSHIP FORM**

**Individuals**

Investors can elect to take title in their own names; Where two or more investors are pooling their
resources, this can be done by taking title as co-tenants

**Cotenancies**

Cotenancies are not taxpaying entities; Profits and losses accrue to the cotenants as individuals and
are reported on their personal tax returns.
The cotenancy arrangements most commonly encountered are tenancy in common and joint
tenancy

- Joint tenancy—interests of the tenants must be equal; In the event of a joint tenant’s death,
the deceased person’s interest in the property goes to the other joint tenants rather than to the
heirs of the decedent (right of survivorship)
- Tenancy in common—the interests of tenants need not be equal and there is no right of
survivorship

**Corporation**

A corporation may hold property in its own name and buy, sell, and otherwise enter into contracts.
A corporation may be a taxable entity that files a corporate income tax return and must pay taxes
on its earnings; Distribution of corporate earnings in the form of cash dividends is taxable to
corporate stockholders as regular income.

**Advantages**

- Limited shareholder liability—shareholders have no personal liability for corporate obligations
- Asset liquidity—corporate shares may be easier to sell than fractional interests in real estate
- Simplified transactions—transferring ownership of corporate shares is less involved than a direct transfer of real estate interests.
- Simplified estate settlement procedures—if realty is in a state other than that of one’s residency, both states might try to collect death taxes; if the realty is owned by a corporation rather than directly by the decedent, this problem is avoided.
- S corporation—corporation formed under subchapter S of the IRC; income is taxed directly to corporate shareholders, thereby avoiding double taxation.

**General partnership**

A partnership is not a taxable entity; prorata shares of income and loss are reported on the partners’ personal tax returns. Partnerships are required to file informational tax returns showing the amount and nature of income, expenses, deductions, and allocations among partners. Partners share all profits and losses equally unless they agree upon an alternative arrangement. In the absence of special wording in the partnership agreement, they also have equal authority over the activities of the partnership business. The partners are jointly and severally liable for all partnership obligations, even if the obligation is created as a consequence of one partner having exceeded the authority granted under the partnership agreement. Shared management authority, combined with unlimited joint and several liability, place significant limitations upon the usefulness of general partnerships as real estate ownership entities.

**Limited partnership**

A limited partnership is a partnership of one or more general partners and one or more limited partners. Prorata shares of limited partnership income and loss are reported directly on the partners’ personal tax returns. A limited partnership must file an informational tax return showing the amount and nature of income, expenses, deductions, and allocations. The general partner(s) are charged with conducting partnership business affairs and have unlimited personal liability for partnership obligations. The limited partner(s) have no personal liability but share in partnership profits and losses in the same way partners do in a general partnership. An organization is treated as a partnership for tax purposes only if it does not have more corporate than partnership characteristics; otherwise, it is considered an association to be taxed as a corporation. Passive activity rules (code section 409) apply to all limited partnership interests; i.e., losses from passive activities can only be offset against gains from passive activities, not against ordinary income from activities that are not classified as passive.

**Limited liability Company**

Instead of shareholders or partners, an LLC has members; None of the members has personal liability for the company’s financial obligations, yet the LLC (if properly structured) has the same income tax pass-through characteristics as a limited partnership.

**TAX CONSEQUENCES OF PROPERTY SALES**

The adjusted tax basis at time of sale is the initial tax basis plus all additional capital investments, minus cumulative depreciation allowances, plus-or-minus certain other adjustments that may sometimes apply. The gain or loss on a property’s sale is the difference between the value of consideration received and the adjusted tax basis at the time of the transaction.
TAX CONSEQUENCES OF FINANCIAL LEVERAGE
Borrowing and repaying debts are not taxable events; However, interest expense is usually deductible in the year the interest is paid.
An exception to the general rule that interest is tax deductible in the year paid applies to prepaid interest—it is generally not deductible until actually earned by the lender; Consequently, loan origination fees and discount points on loans to finance business or investment property, must be amortized over the term of the loan; There is an exception for loans to finance a personal residence.
Construction period interest is also an exception—it must be capitalized and will be reflected in annual depreciation allowances.
The deductibility of mortgage interest is limited by the passive asset loss limitation rules.
Selling a property usually triggers a taxable gain while borrowing does not; Therefore investors may be better off borrowing against their equity rather than selling.

INCOME TAX CREDITS
Tax credits are direct, dollar-for-dollar offsets against one’s income tax obligation; The consequences of tax deductions depend on one’s marginal income tax bracket.
Tax credits are available for certain types of affordable housing and historic rehabilitation projects.
Because the tax credits can be sold, they are a potential source of equity to a project.

Financial Example:
Maegen’s Magic Manor was recently listed on the National Register of Historic Places, thereby qualifying it for tax credits equal to 20% of qualified rehabilitation costs. After you buy the property, you will spend $5,000 per unit for qualified rehabilitation. Model ways in which the tax credits may be employed in your proforma.

LIMITATIONS ON DEDUCTIBILITY OF LOSSES
A limited partnership investment is considered a passive activity; As such, deduction of passive losses is limited to the amount of offsetting passive income.
Real estate held for rental purposes is classified as a passive asset unless it is incidental to the primary business activity or the taxpayer is actively engaged in a real property trade or business such as brokerage, development or management; Actively engaged implies:
- Spending more than half of one’s working hours (and in any event, more than 750 hours per year) in the trade or business, and
- Owning at least a five percent interest in the business entity.
A special exception permits real estate investors who are not actively engaged in a real estate trade or business to deduct up to $25,000 of passive losses each year.
The taxpayer must have at least a 10% interest (and not as a limited partner) and must be an active participant in the operation of the rental property; Active participant means the taxpayer (or the taxpayer’s spouse) must play some significant role, such as arranging for services to be provided, or approving tenants.
The exception is phased out ratably as the taxpayer’s adjusted gross income (before subtracting the passive asset loss) moves from $100,000 to $150,000.

COMPUTING THE REALIZED GAIN OR LOSS
Everything of economic value received in exchange for a property comprises the consideration; This includes the balance due on any mortgage to which the property remains subject, whether or not the purchaser assumes personal liability.
If the seller receives other property or services as a part of the transaction, these must be included at their fair market value.
The difference between the consideration received and the adjusted tax basis at the time of the transaction is the realized gain or loss on disposal.
TAX TREATMENT OF REALIZED GAINS

Gains are ordinary income when they result from recapture of depreciation allowances. This might occur when an owner has put property into use prior to January 1986, and elected to use an accelerated depreciation method. Depending on the rules that were applicable when the property was put into productive use, the gain on disposal might be treated as ordinary income due to recapture of depreciation, to the extent of the excess of accelerated over straight-line depreciation, or to the full extent of depreciation allowances taken.

Gains are ordinary income when they result from selling real estate that has been held for resale in the normal course of business (dealer property). Gains on the sale or exchange of real estate held for business or investment purposes are capital gains; if the holding period exceeds one year, the gain is a long-term capital gain.

Tax treatment of realized losses

Real estate used in a trade or business (including actively managed rental property) and held for more than one year are called section 1231 assets; although gains on their disposal are treated as capital gains, losses are treated as offsets against ordinary income. Losses on real estate held for investment purposes (not used in a trade or business, including rental in which the owner is actively engaged in management) are capital losses; if the real estate is held for more than one year, the loss is a long-term capital loss.

Computing the net gain or loss on capital transactions and on the sale of assets held for use in a trade or business is a multiple-step process:

- Offset section 1231 gains and losses against each other; if there is a net section 1231 loss, it is offset against ordinary income. If there is a net section 1231 gain, it is grouped with long-term capital gains.
- Offset long-term capital gains (including net section 1231 gains, if any) against long-term capital losses.
- Offset short-term capital gains against short-term capital losses (gains and losses on capital assets held for no more than one year).
- If there are net losses in one category (long-term or short-term) and gains in the other, offset the two; the tax consequences depend on the outcome of this offsetting of gains and losses.
- If the outcome is net short-term gains, lump them with ordinary income.
- If the outcome is net long-term gains, they are taxed at a maximum rate of 20 percent, regardless of the taxpayer's marginal tax bracket; recovery of straight-line depreciation is taxed at 25 percent.

Investment real-estate gains are tricky since they can be taxed in two different ways. If you claim depreciation deductions, at least some of those gains (so-called unrecaptured Section 1250 gains) are taxed at a maximum rate of 25 percent.

For example, say you own a rental duplex and have deducted $32,000 of depreciation over the years. That depreciation reduces your basis in the property and results in a bigger taxable gain (or smaller loss) when you sell. Now you sell in 2004 for a $100,000 gain. The first $32,000 (the unrecaptured Section 1250 gain) is taxed at a maximum rate of 25%. The remaining $68,000 of gain is taxed at the "general rule" maximum rate of 15%.

If the outcome is net losses, they are offset against ordinary income on a dollar-for-dollar basis, but only to the extent of $3,000 per year. Any net losses in excess of $3,000 must be carried forward and included with capital transactions next year; they retain their character (as long-term or short-term) when carried forward.

LIKE-KIND EXCHANGES

An otherwise taxable gain realized on an exchange of like-kind assets need not be recognized in the year of the transaction; rather, the tax liability is postponed until a future, taxable transaction occurs with respect to the newly acquired property.
Enabling legislation for like-kind exchanges, sometimes (erroneously) called tax-free exchanges, is contained in Section 1031 of the internal revenue code. Reflecting this, they are sometimes referred to simply as Section 1031 exchanges.

To qualify under section 1031:
- There must have been a bona fide exchange of the assets involved
- No actual or constructive receipt of cash
- Exchange must have been planned all along
- Documentation must show that an exchange was planned and executed properly

Property conveyed must have been held for productive use in a trade or business or as an investment and must be exchanged for like-kind property that is also to be used in a trade or business or held as an investment.

"Like-kind" relates to the nature of the property, not to its quality or grade. Examples issued by the treasury to amplify this point include:
- Property held for use in trade or business, together with cash, for other property intended for use in a trade or business
- Urban real estate for a farm or ranch
- Improved or unimproved real estate held for investment purposes
- A leasehold (with not less than 30 years to run) for a freehold.

Certain types of property, are specifically excluded from section 1031 including securities or evidence of indebtedness (stocks, bonds, notes, etc.), beneficial interest in a trust, and inventory.

Foreign real estate is never considered like-kind with domestic real estate.

**Tax consequences of like-kind exchanges**

If all property involved in an exchange qualifies as like-kind and all parties qualify, then no party to the exchange may recognize any gain or loss on the transaction.

Should some of the property involved in an exchange fail the like-kind test, then some portion of a gain (but not of a loss) must be recognized in the year of the transaction; The balance of the realized gain is deferred as before and is reflected in the adjusted basis of acquired property.

The test of whether a transaction qualifies as a tax-deferred exchange is applied separately to each party to the trade.

To qualify, individuals must not have held their property for resale or for personal use; Both the initial and the substitute property must be held either as an investment or for use in a trade or business (but not as inventory).

If one party’s motive for ownership was inappropriate under section 1031, the other party to the transaction may nevertheless qualify.

Receipt of property that does not meet the like-kind definition has the effect of partially disqualifying a gain from deferral.

The person receiving unlike property, or boot, must recognize any gain realized on the transaction to the extent of the boot received.

Boot includes anything of economic value other than like-kind assets involved in the transaction; Examples include cash, services rendered or an obligation to render services, debt forgiveness, or a promise to convey something of value in the future.

It is rarely practical for properties to be exchanged directly and simultaneously; the IRC allows for a third party intermediary (maybe as simple as an escrow account) to accommodate and exchange; this type of deferred exchange is called a Starker exchange and is the most common type of exchange.

- The seller sells property
- Sale proceeds go into an intermediary account
- Seller identifies up to three potential exchange properties within statutory time frame (45 days)
- Intermediary buys property and exchanges title to Seller
- Seller must receive title to the target property within 180 days of the sale of Seller’s original property