TALKING WITH ACCOUNTANTS ABOUT INCOME-PRODUCING REAL ESTATE

by Jack P. Friedman, CRE

Real estate investors, like everyone else, react to accounting and taxation dictates. Their accountants tell them how much they made or lost in a year, and their tax experts discuss submitting last year's results to the Internal Revenue Service and planning ahead to minimize future taxation.

Taxation certainly motivates real estate development. The 1981 Tax Reform Act gave great tax advantages to equity real estate investors, thus creating new development opportunities and higher prices; the 1986 act removed these incentives, and many hold it responsible for the ensuing real estate bust. The 1993 act generally was neutral. Equity investors are certainly motivated by accounting-defined income and taxation, yet real estate counselors do not always consider the accounting or tax situation of a proposed transaction or investment.

This is not to imply that a tax or financial accounting practitioner can provide more meaningful information than a skilled real estate counselor. It's just that their perspectives are different. The accountant is able to provide financial statement presentation or tax implications of a proposed transaction through a mechanical extrapolation of market data with the assumptions supplied by a client (developer, syndicator or broker) or to record historical data. The real estate counselor usually seeks out market data independently.

While accountants and real estate counselors share the same words, their usage provides entirely different meanings. Now that many Big Six accounting firms offer real estate consulting services, the chasm is more apparent between tax, audit and management consulting services, even within a firm. This article focuses on differences between tax, accounting and real estate consulting matters regarding income-producing property. It will begin with terminology differences and proceed to after-tax cash flow and resale analyses.

Terminology Differences

Some of the terms commonly used in both real estate consulting and tax and financial accounting which take on different meanings are *amortization, capitalization, cash flow, depreciation, gain from sale, net income, net operating income* and *value.*

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Amortization:
Real estate counseling: the systematic reduction of a mortgage loan, through periodic payments in excess of interest.

Tax, accounting: (1) The systematic write-off of the cost of an intangible asset over its expected life. For example, leasing commissions are set up as an intangible asset on a financial statement and deducted ratably over the lease term. The same is true of mortgage placement fees. (2) Same as the real estate definition.

Capitalization:
Real estate counseling: Conversion of an expected stream of income into one lump sum amount of present value.

Accounting: Recording on the entity's balance sheet the cost of an asset having a useful life of more than one year.

Cash Flow:
Real estate counseling: (1) Rental income minus all cash outflows to operate and finance property. (2) In certain computer programs, including *PROJECT,* net operating income minus leasing commissions and tenant improvements.

Accounting: Rental income minus operating expenses and financing payments. This may also be called before-tax cash flow.

Tax accounting defines *after-tax cash flow:* Accounting definition of *cash flow,* plus any income tax savings attributable to owning the property, or minus income taxes due to property ownership.

Depreciation:
Real estate counseling: (1) Loss in value from original cost.

Real estate appraisal: (1) Loss in value from current replacement or reproduction cost new. (2) In Ellwood formulation, expected loss in value over a future holding period.

Accounting: Method of allocating cost over estimated useful life.

Tax accounting: Method of allocating tax basis over an arbitrary period of time specified by tax law.

Gain From Sale:
Real estate counseling: Enhancement in value from original cost.

Tax or accounting: Difference, selling price minus expenses of sale; and original cost minus (tax) depreciation.

Net Income:
Accounting, taxation: Rental revenue minus the sum of: operating expenses, interest expense, amortization of intangible assets and tax or accounting depreciation. Replacement reserves and mortgage principal payments are not subtracted.

Net Operating Income (NOI):
Real estate counseling: Potential gross rental income, after deducting allowances for vacancies and collections, operating expenses and replacement reserves. Financing expenses and depreciation deductions are not subtracted.

Value:
Book value is a financial accounting term for an asset presented on the balance sheet. It is generally based on historic cost, reduced by accumulated book depreciation. Compare with *adjusted tax basis,* a similar term for tax purposes (tax cost minus accumulated tax depreciation). Contrast with *market value,* an economic term meaning what it could be expected to sell for under certain conditions.

Major Differences Between Tax And Financial Accounting Practitioners
Though it may be convenient to treat all accountants as one group, such a description is inappropriate for our discussion. Financial accountants are concerned with Generally Accepted Accounting Principles (GAAP), a set of rules that govern financial statement presentation. Tax accountants are concerned with the Internal Revenue Code (IRC), which applies a different set of rules. Many of these differences revolve around issues of timing and accrual of income recognition and expense deductions.

Cash-basis accounting recognizes revenue and expenses when they are received or disbursed, rather than when they are earned or incurred. Using an *accrual basis,* revenue is recognized when earned and expenses when incurred. For example, salaries may be paid on January 2 for work performed in December. On an accrual basis, salaries are expenses of the prior year, whereas on a cash basis, the salaries are an expense when paid.

Tax rules, however, may preempt consistent accounting. Rents received or accrued in advance, for example, are taxable income to the lessor, under IRC Section 61. That is, rents received in advance are taxable income regardless of whether the taxpayer is on an accrual basis or a cash basis. By contrast, financial accounting demands a matching of costs with revenues. For financial reporting purposes, advance rent is not treated as revenue until it is earned. A guide for recognition of revenues and other important matters is the Financial Accounting Standard Board's (FASB) Statement of Financial Accounting Concepts (SFAC) No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises." It states that revenue generally is recognized when both these conditions are met: (1) The revenue is realized or realizable, and (2) the

revenue is earned. Thus, for financial reporting purposes, rent received in advance is not treated as revenue when received, but rather as revenue in the period it is earned.

Depreciation claimed for tax purposes is done according to arbitrary IRS rules. Through the years the IRS has changed allowable depreciable lives and methods a number of times. Before 1981, most commercial property was to be depreciated for tax purposes under "guideline lives," generally 40 years or more. However, if an owner could demonstrate that a shorter life was in order, it could be used. Component depreciation was allowed whereby taxpayers could elect to depreciate different components of a building over different useful lives. In the 1970s, most new property bought could be depreciated using an accelerated method, whereas second-owner property bought was to be on a straight-line basis. For most purchases in 1981-1983, a tax depreciation life of 15 years was allowed with an accelerated method though component depreciation was barred. The life was raised to 18 years in 1984 and 19 years in 1985. Events changed dramatically with the Tax Reform Act of 1986. The tax depreciable life was raised dramatically to 31.5 years for commercial property (27.5 years for apartments) and the straight-line method mandated. For purposes of commercial property tax depreciation, lives were extended to 39 years in the 1993 tax act.

By contrast, the aim of *depreciation expense for financial accounting* purposes has not changed through the years. Its purpose is to match costs with revenues. A building with a 50-year expected useful life is to be depreciated over that period. If greater depreciation is expected during the early years (as an analogy, an automobile depreciates more early in its life than it does later), the financial accountant should provide an accelerated depreciation schedule. Whether tax or financial accounting is used, depreciation accounting is a method of systematic allocation, not of valuation. Accounting or tax depreciation allocates the cost of an asset over some period of time.

There may be differences in accounting for operating expenses, e.g., tax vs. financial accounting. For example, suppose the building has been built on leased land. First consideration must be given to whether the lease is a true (operating) lease or a financing device. Rules for tax purposes differ from financial accounting. If the lease is a financing device, then the rent payments are recast to become interest and principal.

Suppose, instead, it is found to be an operating lease. If the rent is prepaid, the taxpayer may deduct only the portion of rent that applies to the current tax year. As noted earlier, however, the lessor who receives rent in advance must report it on the tax return in the year received or accrued. There is not symmetry between the payor and recipient of advance rent for tax purposes. For financial accounting purposes, there should be symmetry.

Differences in tax and financial accounting purposes may be significant. Corporations and partnerships must, on their annual tax returns, provide a reconciliation of their books with their tax returns. This is done on Schedules M-1, Reconciliation of Income (Loss) per Books with Income (Loss) per Return, and M-2, Analysis of Unappropriated Retained Earnings Per Books (for corporations) or Analysis of Partners' Capital Accounts (for partnerships).

Major Differences Between Real Estate Counseling And Tax Accounting

The real estate counselor typically builds a cash flow model as shown in Table 1:

TABLE 1

Cash Flow Estimated By Real Estate Counselor

Rental income available:		
50,000 sq. ft. at $20 psf		$1,000,000
Add: Miscellaneous income		25,000
Equals: Potential gross income		1,025,000
Less: Vacancy and collection allowance		−100,000
Equals: Effective gross income		925,000
Operating expenses:		
Advertising	$ 30,000	
Insurance	28,000	
Grounds maintenance	20,000	
Management	56,000	
Payroll	48,000	
Payroll taxes	9,000	
Repairs	45,000	
Taxes (ad valorem)	175,000	
Utilities	54,000	
Subtotal	465,000	
Replacement reserves (carpets, appliances)	35,000	
Total		500,000
Net operating income*		425,000
Less: Leasing commissions	30,000	
Tenant improvements	40,000	−70,000
Net operating income†		355,000
Less: Debt service		−300,000
Cash flow (also called before-tax cash flow)		$55,000

*Traditional net operating income computation.

†Net operating income after leasing commissions and tenant improvements. A computer program, *PRO-JECT*, refers to this as cash flow.

By contrast, a tax accountant estimates income or loss for the same property as shown in Table 2:

TABLE 2

Taxable Income (Or Loss) As Estimated By Tax Accountant

Rental revenue		$ 900,000
Miscellaneous revenue		25,000
Total revenue		925,000
Deductible expenses:		
Advertising	$ 30,000	
Insurance	28,000	
Grounds maintenance	20,000	
Management	56,000	
Payroll	48,000	
Payroll taxes	9,000	
Repairs	45,000	
Taxes (ad valorem)	175,000	
Utilities	54,000	
[Subtotal memo]	465,000	
Interest expense	250,000	
Depreciation:		
Building cost: $5,000,000		
Useful life: 40 years	125,000	
Appliances, carpets at cost: $500,000		
Useful life: 5 years	100,000	
Land cost: $330,000 (not depreciable)		
Amortization:		
Leasing commissions: $30,000		
Lease term: 5 years	6,000	
Unamortized mortgage fees: $100,000		
Remaining mortgage term: 25 years	4,000	
Tenant improvements: $40,000		
Term 20 years:	2,000	
Total expenses		$ 952,000
Taxable income		($ 27,000)

At this juncture, it may be instructive to describe the differences between tax and real estate counseling methodology, especially for each of the items where there is a difference. These are reconciled on Table 3.

Potential gross income. This term is used by the real estate counselor to describe the rent collections if all units are fully leased. It tends to be a hypothetical figure that serves as a basis for estimating the amount that will *not* be collected due to vacancies and collection losses. Some real estate counselors include miscellaneous income (concessions, tenant security deposits forfeited, interest on a replacement reserve) in this figure; in other situations, the miscellaneous income is not included in potential gross income.

For accounting and tax purposes, there is no such thing as potential gross income, nor a vacancy and collection allowance. The accountant is interested in what was accrued or collected, not what was missed. The counselor needs vacancy information to help decipher the market and understand this property in relation to other properties in the market.

Operating expenses. For real estate, tax and accounting there should be few differences, unless the owner is on an accrual basis for one purpose and a cash basis for another. These should be ordinary and necessary amounts that are needed to operate the property. However, a replacement reserve is not tax deductible.

Replacement reserves. The real estate counselor often regards the wear on short-lived components, such as appliances and carpets, as an operating expense that is properly accounted for by spreading the replacement costs over their expected lives. For example, suppose that carpeting in an apartment complex is expected to last an average of five years. If the replacement cost is $10,000, then, in theory, the owner should put aside $2,000 each year to stabilize the expenses (and net operating income). This avoids possible lumpiness of NOI, which is important in order to avoid capitalization into a value estimate of too much or too little. However, few owners actually put amounts aside in a replacement reserve; they do so only when required by lenders or government agencies.

For accounting purposes, there is no replacement reserve. Instead, the historical cost of the asset is depreciated over a period of time that is related to the asset's expected useful life. The same is true for tax purposes, except that the depreciable life applied is legislated and not necessarily related to the expected life of the asset.

Leasing commissions and tenant improvements. The real estate counselor might assert that these are nonrecurring capital expenditures that should not reduce net operating income. Certain computer programs widely used by real estate counselors provide results that conform to this notion. Real estate textbooks describe them both ways, as deductions to derive net operating income or from that amount to derive cash flow.

For tax and accounting purposes, these amounts are capitalized and amortized generally over the period of time for which they are expected to provide useful benefit. This is ordinarily the life of the lease or the tenant improvement. One concern here is when a tenant improvement is expected to outlast the term of the tenant's lease. In that case, the improvement is amortized over its useful life; if the tenant vacates while there is still a balance left to amortize and the improvement is torn out as useless to another tenant, the unamortized remainder is tax deductible.

Cash flow. This term is also known as *before-tax cash flow* and *cash throw-off*. It has customarily been used to describe the amount of cash available after deducting debt service, which includes both interest and principal repayment from net operating income. There are a number of computer programs in use by real estate counselors that attempt to define cash flow as net operating income minus leasing commissions and tenant improvements without considering debt service. Yet, without including debt service the definition of cash flow is inadequate or ambiguous.

Before-tax cash flow generally follows the real estate considerations described above, though the replacement reserve is a questionable item. Also, the lumpiness of tenant improvements and leasing commissions should be smoothed out if a single-period NOI is to be capitalized into a value estimate. In a multi-period discounted cash flow analysis, the future cash in- and outflows are articulated so they appear in the year they are expected to occur.

The definition of cash flow should be qualified as to before-tax or after-tax. "Tax," in this sense, relates to income taxes as contrasted with ad valorem property taxes that are operating expenses which are subtracted to derive cash flow.

Income taxes payable (or saved) due to project ownership are subtracted from (or added to) before-tax cash flow to derive after-tax cash flow. A computation of taxable income is necessary. Basically, rent collected, plus miscellaneous income, minus tax-deductible ordinary and necessary operating expenses, is used to derive taxable income. Tax-deductible expenses, in addition to operating expenses, include interest, tax depreciation and amortization of intangible expenses. However, a replacement reserve is not deductible, nor is the amortization payment for mortgage reduction.

When there is taxable income, it is added to the investor's other (nonproject) income to derive the investor's total taxable income. The investor's tax burden, added by the project income, is estimated. For simplicity, one flat rate often is applied as the marginal rate to represent the tax paid on the next dollar of income.

When there is a tax loss from project ownership, there may or may not be a current tax savings depending on a number of variables. First, philosophically, should a tax savings which is due to shielding nonproject income from taxation be attributed to the project? If so, it may create a false sense of additional value to the project. Proponents of adding tax saving as a benefit may assert that the loss often is caused by a non-cash tax deduction for tax depreciation. Therefore, it is only a paper loss, and, second, it results in saving tax money that was made possible only from project ownership. So why shouldn't this benefit be associated with the investment? To the contrary, others argue. The savings was a reduction of tax that was assessed on nonproject income. Some assert it is wrong to ascribe a value to the real estate investment on the basis of either income tax losses or anything related to income that was earned outside the property.

The 1986 Tax Law And Depreciation Schedules

The 1986 tax law brought major changes in depreciation schedules that serve to reduce the potential for a tax loss. The most significant was the change in the depreciable life from 19 years and an accelerated schedule to 31.5 years, straight-line, for commercial property, then extended to 39 years by the 1993 tax act. Depreciation of apartments was changed to 27.5 years in 1986, also straight-line, and still remains there. So now the likelihood of a tax loss from a paper tax deduction is lessened due to the reduced depreciation allowance.

If there is a tax loss, its application depends on a variety of factors. Generally, the tax loss is called a passive activity loss (PAL). This cannot be applied against other income, though there are two important exceptions. A PAL is suspended to be released against a passive income generator (PIG). That is, when the property (or other real estate the taxpayer owns) begins to earn taxable income, the PALs are released to offset PIGs. When they are not released against PIGs, they remain suspended until a property sale when they are released to offset a taxable gain.

Starting in 1994, one important exception applies to small investors, the other to real estate professionals. For small investors, up to $25,000 of loss may be used as an offset to nonproject income by an owner who manages his own property. However, this opportunity is limited and begins to be phased out for taxpayers with more than $100,000 of taxable income from nonproject sources, and is unavailable when nonproject taxable income is above $150,000.

The other exception, beginning in 1994, is for real estate professionals. To qualify as a real estate professional, one must meet two requirements:

1. More than one-half of the personal services performed in trades or business during the tax year must involve real property trades or business in which one materially participates.
2. One must perform more than 750 hours of service during the tax year in real property trades or businesses in which one materially participates.

These two requirements must be satisfied by one spouse if a joint return is filed.

Taxable Income Vs. Cash Flow

Most real estate counselors in addressing income-producing real estate are concerned with deriving cash flow as an intermediate step in the valuation process. Most accountants, whether tax or financial,

are concerned with deriving net income. The most significant differences between the two can be gleaned from Tables 1 and 2. These are:

1. *Accounting or tax depreciation.* This is needed to derive income or loss, but has no effect on before-tax cash flow.
2. *Amortization of intangible assets.* This has the same characteristics as accounting or tax depreciation already noted.
3. *Tenant improvements and leasing commissions.* This requires a cash payment and is amortizable for accounting and tax purposes.
4. *Amortization of mortgage balance (principal payment).* This requires a cash payment, but is not deductible to derive tax or accounting income.
5. *Replacement reserve.* This requires a cash payment but is not deductible for tax or accounting purposes.

To derive taxable income from the computation of cash flow is not difficult. Starting with cash flow, subtract tax-deductible items that don't affect cash flow: specifically tax depreciation and amortization of deferred charges. Then, add items that require cash payments but are not tax deductible: specifically, tenant improvements and leasing commissions paid with cash, mortgage principal payments and replacement reserves. The application in Table 3 ties together Tables 1 and 2.

Taxable income (or loss) is not the tax paid (or saved). The tax is a fraction of the amount that is taxable, such fraction ranging from 0 to 40%. In this example, a 40% rate was applied.

Reasons For Differences: Accounting Vs. Real Estate Counseling

The art of accounting developed with an orientation to match costs with revenues. This included depreciation as a systematic deduction to account for the original cost of a wasting asset over its estimated useful life in which it is used up in production. That is, the acquisition of an asset gives rise to neither gain nor loss, but its use over time is treated as an expense whose cost is spread over this period. Paying interest on a loan is an expense, but repaying the principal is not. Placing money in a replacement reserve is a form of savings, creating neither income nor expense.

By contrast, real estate counselors seek annual cash flow. The effort is to measure the present value of expected cash flow. This relegates an allocation of historical cost as a meaningless exercise. Repayment of mortgage principal or setting aside money in a replacement reserve to replace worn out assets requires cash payments. Depreciation is measured by a reduction in value between the current date and some expected future time of resale. A capitalization rate can account for expected gain (or loss) in value by subtracting (or adding) a capital recovery provision to the discount rate to derive the capitalization rate.

TABLE 3

Reconciliation Of Cash Flow With Taxable Income

Cash flow from Table 1		$ 55,000
Subtract non-cash tax deductions:		
Depreciation expense:		
$125,000 + $100,000	$225,000	
Amortization expense:		
$4,000 + $6,000 + $2,000	12,000	−237,000
Add cash payments that are not tax deductible:		
Tenant improvements and leasing commission	70,000	
Mortgage amortization	50,000	
Replacement reserve	35,000	+155,000
Taxable income (agrees with Table 2)		(27,000)
Tax savings at 40% bracket applied to $27,000 tax loss (Can be used by investors with PIGs, small investors to $25,000 of loss, and real estate professionals beginning in 1994.)		10,800
After-tax cash flow: $55,000 from property operations plus $10,800 tax savings equals		$ 65,800

Proceeds From Resale Vs. Gain Or Loss

A real estate counselor, when providing a discounted cash flow (DCF) analysis, typically prepares an 11-year projection of cash flows from operations. The first 10 years are used in the calculation on the value of results from operations; the eleventh year is presented for purposes of determining the expected resale price. This resale amount, expected to be received at the end of the tenth year, is based on the forecast NOI for the eleventh year. This amount need not arise from a resale; it can also be thought of as the present value of all net operating income to the owner after the tenth year.

In the following example, the resale is provided after 5 years rather than 10 years to keep computations within this projection to an easily followable size.

In a projection prepared for tax or accounting purposes, all aspects of a resale are considered, e.g., transaction costs, paying off the remaining mortgage balance and a tax on the gain. Consider Tables 4 and 5.

One should note the significant difference between Tables 4 and 5. Table 4, which would be prepared by a tax accountant, offers the amount of gain and tax on gain. Table 5, which would be prepared by a real estate counselor except for the tax on gain, offers the cash proceeds from resale.

TABLE 4

Taxable Gain On Resale And Tax On Resale (Resale in 5 Years)

Resale price		$7,000,000
Less: Expenses of resale		−350,000
Adjusted selling price		6,650,000
Adjusted tax basis:		
Original cost	$6,000,000	
Less:		
Building depreciation: 5 × $125,000	$ 625,000	
Appliance, carpet depreciation: 5 × $100,000	500,000	
Tenant improvements: 5 × $2,000	10,000	
Amortization, leasing commission: 5 × $6,000	30,000	
Amortization, mortgage fees: 5 × $4,000	20,000	
Total	$1,185,000	
Adjusted tax basis		4,815,000
Taxable gain on resale:		1,835,000
Tax on gain at 28%		$ 513,800

TABLE 5

After-Tax Proceeds From Resale

Selling price in 5 years	$7,000,000
Less: Expenses of resale	350,000
Adjusted resale price	6,650,000
Less: Mortgage balance at resale	2,250,000
Less: Income tax on gain (see Table 4)	513,800
Net proceeds from resale	$3,886,200

Summary

The real estate counselor and the financial or tax accountant each have their own domain as to what numbers they provide their client, and each has the conviction that his way is correct. They exercise the dogma of their respective professions: cash flow for real estate counseling purposes, net income for financial accounting purposes, taxable income for tax purposes. Though the differences in dollars are large, only a few entries comprise the difference. This is primarily accounting or tax depreciation and amortization, which are deductible for accounting and tax purposes without a cash payment; and mortgage amortization and replacement reserves which require a cash payment but are not deductible for tax or accounting purposes. Although the numbers can be easily reconciled, a philosophy reconciliation of the two professions, accounting and real estate counseling, is not on the horizon.