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Investment characteristics

The idea of investment is simple: take something of value and put it to work in some way to increase its value over time. With any investment, one wants the original investment to grow, without losing it. This idea is called **conservation of capital**. Unfortunately, no investment is truly secure. External conditions change, and the investment itself can change. Even if you do nothing with it, its value does not remain constant.

Risk versus return. The general rule in investments is that the safer the investment, the more slowly it gains in value. The more you want it to gain, and the more quickly, the more you must risk losing it. How much do you want to earn, and how much are you willing to risk to earn it? Reward in investing corresponds directly to the degree of risk.

Management. Another aspect of investment is the amount of attention you must pay to it to make it work. You can deposit cash in a passbook account and forget about it. You can use your cash to buy a business and then run the business yourself to make your asset grow and earn. How much do you want to be involved in managing your investment?

Liquidity. The issue of exchangeability is an important one in investment. How easy is it to recover your invested resource, without loss, and exchange it for another one that you want? If there is a **market** for the type of resource you have--other people want to buy and sell it for themselves-- your investment is **liquid**. The most liquid form of financial investment is generally cash, since cash is itself a medium of exchange and people always want it. A more illiquid investment is one which takes a long time to exchange for something you prefer to own. How long are you willing to wait to recover your invested resource and its earnings?

Rewards

The basic aim of financial investment is to increase one's wealth, to add value to what you have. This can occur in several ways.

Income. An investment can generate income in some way on a periodic basis. You may consume this cash, spending it for goods and services that, when used up, have no further value. Or, you may use the cash to put into another investment.

Appreciation. Your invested asset itself may gain value over time because of an increase in market demand for it. When you sell or exchange it for something else you prefer to have, you get more than you originally put into the investment.

Leverage. You may pledge the value of your resource to borrow funds in order to make an investment that is larger than your own resource permits you to do directly. The small resource is used as a lever to make a larger investment, and thus increases your opportunity to benefit from income, appreciation, and the other rewards of investment.

Tax benefits. Some investments receive treatment under tax laws that enables the investor to reduce or defer the amount of tax owed. Tax dollars you don't have to pay are dollars you have available for some other use, such as consuming or further investing.

Risks

Investment risks come from a variety of general sources, including the market, business operations, the value of money, and changes in the interest rate.

Market risk. Changes in the demand for your invested resource may cause your investment to lose value and to become illiquid.

Business risk. Changes in the operation of a business with which your investment is connected may reduce or eliminate the income- and appreciation-earning capacity of your investment.

Purchasing power risk. Changes in the value of money as an exchange medium, such as through inflation, may decrease the practical value of your invested resource.

Financial risk. Changes in financial markets, particularly in interest rates, may reduce the value of your investment by making it less desirable to others and by making it more expensive for you to maintain.

An investment may fail to produce any or all of the desired investment rewards listed earlier. The expected income may not be realized. The invested asset may fail to appreciate as expected. It may even decline in value. Perhaps even worse, you may be called on to **add** to the investment just to keep it in place. Your leverage may turn against you, becoming **negative leverage**. This is the situation when your cost of borrowing funds to make the investment becomes greater than the income the investment returns to you. Finally, your expectation of a tax advantage may be disappointed. Tax laws are constantly changing.

Types of investments

Four of the most important types of investment are investments in money, equity, debt, and real estate.

Money investments. A money investment is one in which the basic form of the investment remains money. Examples are: deposit accounts, certificates of deposit, money funds, and annuities. The basic reward from a money investment comes in the form of interest. Money investments are relatively safe, with correspondingly conservative rates of return.

Debt investments. A debt investment is one in which an investor buys a debt instrument. Examples are bonds, notes, mortgages, and bond mutual funds. The basic reward comes in the form of interest. Debt investments are usually riskier than money investments and less risky than stocks or real estate.

Equity investments. An equity investment is one in which an investor buys an ownership interest in a business concern. Examples are stocks and stock mutual funds. The basic rewards come in the form of dividends and appreciation of share value. Equity investments are generally riskier than money and debt investments.

Real estate investments. A real estate investment is one in which an investor *buys real estate for its investment benefits rather than primarily for its utility*. It may have the features of both an equity and debt investment, depending on the type of real estate involved and numerous other factors, such as the type of interest one owns. A real estate investor may invest in an income-producing property or a non-income producing property.

- ▶ **Non-income property**

a residential property used as the investor's primary residence. The basic reward, beyond the enjoyment of use, comes in the form of appreciation. There may also be tax benefits, depending on how the purchase is financed.

- ▶ **Income property**

a property owned specifically for the investment rewards it offers. Examples are multi-family residential properties, retail stores, industrial properties, and office buildings. Rewards come in any or all of the forms mentioned earlier: income, appreciation, leverage and tax advantages.

REAL ESTATE AS AN INVESTMENT

Risk and reward

Illiquidity

Management requirements

Real estate investments participate in the general risks and rewards of all investments. However, real estate investments are often complex. They are also distinguished by their lack of liquidity and by the amount of management they require. In addition, each investor has specific aims and circumstances that affect the viability of any particular real estate investment for that individual. Licensees who lack expertise in the area of real estate investment analysis should refer potential investors to a competent advisor. Nevertheless, a licensee should be familiar with the basics of real estate as an investment.

Risk and reward

Capital put into real estate is always subject to the full range of risk factors: market changes, income shortfalls, negative leverage, tax law changes, and poor overall return.

Market demand for a specific type of property can decline. For example, a business district's retailers may vacate stores in an area in order to obtain better space in a new shopping center. Market downturns leave the income property investor with an unmarketable property or one which can only be re-leased at a loss of some portion of the original investment. Thus the expected reward from income or appreciation may never be obtained.

Another risk of the investment property is the cost of development or operation. If start-up costs or ongoing operating costs exceed rental income, the owner must dip into additional capital resources to maintain the investment until its income increases. If income does not rise, or if costs do not decline, the investor can simply run out of money.

Leverage is a constant risk in real estate investment. If the property fails to generate sufficient revenue, the costs of borrowed money can bankrupt the owner, just as development and operating costs can. Investors often overlook the fact that leverage only works when the yield on the investment exceeds the costs of borrowed funds.

Tax law is an ongoing risk in long-term real estate investment. If the investor's tax circumstances change, or if the tax laws do, the investor may end up paying more capital gains and income taxes than planned, undermining the return on the investment. An investor needs to consider carefully the value of such potential tax benefits as deductions for mortgage interest, tax losses, deferred gains, exemptions, and tax credits for certain types of real estate investment.

Another consideration is *opportunity cost*. Opportunity cost is the return that an investor could earn on capital invested with minimal risk. If the real estate investment, with all its attendant risk, cannot yield a greater return than an

investment elsewhere involving less risk, then the opportunity cost is too high for the real estate investment. Despite all the risks, real estate remains a popular investment, because, historically, the rewards have outweighed the risks. Real estate has proven to be relatively resistant to adverse inflationary trends that have hurt money, debt, and stock investments. In addition, real estate has proven to be a viable investment in view of the economy's continued expansion over the last fifty years.

Illiquidity

Compared with other classes of investment, real estate is relatively illiquid. Even in the case of liquidating a single-family residence, one can expect a marketing period of at least several months in most markets. In addition, it takes time for the buyer to obtain financing and to complete all the other phases of closing the transaction. Commercial and investment properties can take much longer, depending on market conditions, leases, construction, permitting, and a host of other factors. The investor who is in a hurry to dispose of such an investment can expect to receive a lower sales price than may be ideal. Compare this with the ease of drawing money out of a bank account or selling a stock.

Management requirements

Real estate tends to require a high degree of investor involvement in management of the investment. Even raw land requires some degree of maintenance to preserve its value: drainage, fencing, payment of taxes, and periodic inspection, to name a few tasks. Improved properties often require extensive management, including repairs, maintenance, onsite leasing, tenant relations, security, and fiscal management.

REAL ESTATE INVESTMENT ENTITIES

Direct
Syndicate and partnership
Real Estate Investment Trust
Real Estate Mortgage Investment Conduit

Direct

Individuals, corporations or other investor entities may invest as **active investors** in a property by buying it directly and taking responsibility for managing and operating the property.

Syndicate and partnership

A real estate **syndicate** is a group of investors who combine resources to buy, develop, and/or operate a property.

A **general partnership** is a syndicate in which all members participate equally in managing the investment and in the profits or losses it generates. The group designates a trustee to hold title in the name of the syndicate.

A **limited partnership** is a syndicate in which a **general partner** organizes, operates and is generally responsible for the partnership's interests in the property. **Limited partners** invest money in the partnership but do not participate in operating the property. These limited partners are **passive investors**.

Real Estate Investment Trust (REIT)

In a Real Estate Investment Trust, investors buy certificates in the trust, and the trust in turn invests in mortgages or real estate. Investors receive income according to the number of shares they own. A trust must receive at least 75% of its income from real estate to qualify as a REIT, and if certain other conditions are met, the trust does not have to pay any corporate income tax.

Real Estate Mortgage Investment Conduit (REMIC)

A REMIC is a kind of partnership entity formed to hold a fixed pool of mortgages that are secured by real property. The entity issues two kinds of interest. Holders of residual interests are treated, for tax purposes, as partners. Holders of regular interests are regarded as owning debt instruments. Income (or loss) received by regular or residual interest holders is treated as **portfolio** income or loss, and is not included in determining losses from **passive** activities.

TAXATION OF REAL ESTATE INVESTMENTS

Taxable income Cost recovery Gain on sale Interest Passive activities

Real estate investments are taxed on the income they produce and on the increase in value, or gain, when the investment is sold. These forms of taxation are distinct from the ad valorem taxation of real estate.

Taxable Income

Taxable income from investment real estate is *the gross income received minus any expenses, deductions or exclusions that current tax law allows*. Taxable income from real estate is added to the investor's other income and taxed at the investor's marginal tax rate. The "Investment Analysis of an Income Property" section below gives details.

Cost recovery

Cost recovery, or **depreciation**, allows the owner of income property to deduct a portion of the property's value from gross income each year over the life of the asset. The "life of the asset" and the deductible portion are defined by law. In theory, the owner recovers the full cost of the investment if it is held to the end of the asset's economic life as defined by the Internal Revenue Service. At the time of selling the asset, the accumulated cost recovery is subtracted from the investment's original value as part of determining the taxable capital gain.

Cost recovery is allowed only for income properties and that portion of a non-income property which is used to produce income. It applies only to improvements. Land cannot be depreciated. The part of a property which can be depreciated is called the **depreciable basis**.

Depreciation schedules. Residential rental properties are depreciated over a period of 27.5 years. The basic annual deduction for such property is 3.636%, with adjustments for the month of the taxable year in which the property was placed in service. Non-residential income properties placed in service after 1994 are depreciated over a period of 39 years (basic annual percentage is 2.564%). The proper method of depreciation should be determined in consultation with a qualified tax advisor.

Gain on sale

When real estate, whether non-income or income, is sold, a *taxable event* occurs. If the sale proceeds *exceed* the original cost of the investment, subject to some adjustments, there is a **capital gain** that is subject to tax. If the sales proceeds are less than the original cost with adjustments, there is a **capital loss**.

1031 (Starker) exchange. An investor can sometimes defer the reporting of gain or loss, and, hence, taxation of gain, by participating in an exchange of like-kind assets. The legislation that deals with like-kind exchanges is contained in Section 1031 of the IRS code. These tax-deferred exchanges are sometimes called **Section 1031 exchanges** and **Starker exchanges**, named for an investor who won a case against the IRS.

To qualify under Section 1031, there must have been a legitimate exchange of the assets involved. The property being transferred must have been held for productive use in a trade or business or held as an investment and must be exchanged for property that will also be used in a trade or business or be held as an investment. Tax on gain is deferred until the investment or business property is sold and not exchanged.

Interest

Mortgage interest incurred by loans to buy, build, or materially improve a primary or secondary residence is deductible from gross income, subject to limitations based on the loan amount and when it was incurred. The interest on a home equity loan may be deducted only if the loan is used to “buy, build or substantially improve” the home that secures the loan. Principal payments on a loan are *not* deductible. Licensees should consult the latest IRS publications for current rules on mortgage interest deduction.

For income properties that are held as investments, interest on debts incurred to finance the investment is deductible as **investment interest** up to the amount of net income received from the property.

Passive activities

Passive activities are business activities in which the taxpayer does not materially participate. Included are interests in **limited partnerships** and **rental** activities. Losses from such activities may be used to offset income from other passive activities. Passive losses, with certain limitations, may be carried forward to future years or accumulated and deducted from capital gain at the time of sale.

INVESTMENT ANALYSIS OF A RESIDENCE

Appreciation
Deductibles
Tax liability
Gains tax exclusion

Investment analysis examines the economic performance of an investment. The analysis includes costs, income, taxation, appreciation, and return.

A property acquired and used as a primary residence is an example of a non-income property. If a portion of a residence is used for business (i.e., a home office), this portion only may be treated as an income property for tax purposes. Since, by definition, a non-income property does not generate income, its value as an investment must come from one or more of the other sources: appreciation, leverage, or tax benefits.

Appreciation

Appreciation is the increase in value of an asset over time. A simple way to estimate appreciation on a primary residence is to subtract the price originally paid from the estimated current market value:

$$\text{Current value} - \text{original price} = \text{total appreciation}$$

For example, if a house was bought for \$300,000 and its estimated market value now is \$400,000, it has appreciated by \$100,000.

Original price:	\$300,000
Current market value:	\$400,000
Total appreciation:	\$100,000

Total appreciation can be stated as a percentage increase over the original price by dividing the estimated total appreciation by the original price.

The house in the last example has appreciated by 33%:

$$\frac{(\text{Total appreciation})}{\text{Original price}} = \% \text{ appreciated}$$

$$\frac{100,000}{300,000} = 33\%$$

To estimate the percentage of *annual appreciation*, divide the percent appreciated by the number of years the house has been owned:

$$\frac{\% \text{ total appreciation}}{\text{years owned}} = \% \text{ appreciation per year}$$

If the house in the previous example has been owned for three years, the annual appreciation has been 11%.

$$\frac{33\%}{3 \text{ years}} = 11\% \text{ appreciation per year}$$

Deductibles

The primary tax benefit available to the owner of a non-income property is the *annual deduction for mortgage interest*. The portion of annual mortgage payments that goes to repay principal must be subtracted to determine the amount paid for interest. Principal repayment is not deductible. Furthermore, depreciation is not allowed for non-income properties. Consult IRS publications for current conditions and limitations for mortgage interest deductibility.

Tax liability

The seller of a principal residence may owe tax on capital gain that results from the sale. The IRS defines gain on the sale of a home as **amount realized** from the sale minus the **adjusted basis** of the home sold.

Amount realized. The amount realized, also known as **net proceeds from sale**, is expressed by the formula:

$$\begin{array}{r} \text{sale price} \\ - \text{costs of sale} \\ \hline \text{amount realized} \end{array}$$

The sale price is the total amount the seller receives for the home. This includes money, notes, mortgages or other debts the buyer assumes as part of the sale.

Costs of sale include brokerage commissions, relevant advertising, legal fees, seller-paid points and other closing costs. Certain *fixing-up expenses*, as discussed further below, can be deducted from the amount realized to derive an **adjusted sale price** for the purpose of postponing taxation on gain.

For example, Larry and Mary sold their home for \$350,000. Their selling costs, including the commission they paid Broker Betty and amounts paid to inspectors, a surveyor, and the title company, amounted to ten percent of the selling price, or \$35,000. The amount they realized from the sale was therefore \$315,000.

Adjusted basis. Basis is a measurement of how much is invested in the property for tax purposes. Assuming that the property was acquired through purchase, the **beginning basis** is the cost of acquiring the property. Cost includes cash and debt obligations, and such other settlement costs as legal and recording fees, abstract fees, surveys, charges for installing utilities, transfer taxes, title insurance, and any other amounts the buyer pays for the seller.

The beginning basis is increased or decreased by certain types of expenditures made while the property is owned. Basis is increased by the cost of **capital improvements** made to the property. Assessments for local improvements such as roads and sidewalks also increase the basis. Examples of capital improvements are: putting on an addition, paving a driveway, replacing a roof, adding central air conditioning, and rewiring the home.

Basis is decreased by any amounts the owner received for such things as easements.

The basic formula for **adjusted basis** is:

$$\begin{array}{r} \text{Beginning basis} \\ + \text{ capital improvements} \\ - \text{ exclusions, credits or other amounts received} \\ \hline \text{adjusted basis} \end{array}$$

For example, Mary and Larry originally paid \$200,000 for their home. They spent an additional \$10,000 on a new central heating and cooling unit. Their adjusted basis at the time of selling it is therefore \$210,000.

Gain on sale. The gain on sale of a primary residence is represented by the basic formula:

$$\begin{array}{r} \text{amount realized (net sales proceeds)} \\ - \text{ adjusted basis} \\ \hline \text{gain on sale} \end{array}$$

Gain on sale, if it does not qualify for an exclusion under current tax law, is taxable.

Exhibit 18.1 Gain on Sale

	Selling price of old home	\$350,000
-	Selling costs	35,000
=	Amount realized	315,000
	Beginning basis of old home	200,000
+	Capital improvements	10,000
=	Adjusted basis of old home	210,000
	Amount realized	315,000
-	Adjusted basis	210,000
=	Gain on sale	105,000

In the case of Mary and Larry, their capital gain was \$315,000 - \$210,000, or \$105,000. They will owe tax on this amount in the year of the sale unless they qualify for the exclusion described below.

Gains tax exclusion Tax law provides an exclusion of \$250,000 for an individual taxpayer and \$500,000 for married taxpayers filing jointly. The exclusion of gain from sale of a residence can be claimed *every two years*, provided the taxpayer

1. owned the property for at least two years during the five years preceding the date of sale;
2. used the property as principal residence for a total of two years during that five-year period;
3. has waited two years since the last use of the exclusion for any sale.

Losses are not deductible, and there is no carry-over of any unused portion of the exclusion. Postponed gains from a previous home sale under the earlier rollover rules reduce the basis of the current home if that home was a qualifying replacement home under the old rule.

INVESTMENT ANALYSIS OF AN INCOME PROPERTY

Pre-tax cash flow

Tax liability

After-tax cash flow

Investment performance

Income properties are those which are held primarily for the generation of income. In addition to commercial and investment properties such as office buildings, this category includes residential rental properties. An important difference between income and non-income properties is that deductions for depreciation are allowed on income properties. Income properties, like non-income properties, generate a gain (or loss) on sale, and they also create an annual income stream. The annual income streams are determined on both a pre-tax and after-tax basis in order to determine the productivity of the investment.

Pre-tax cash flow

Cash flow is the difference between the amount of actual cash flowing into the investment as revenue and out of the investment for expenses, debt service, and all other items. Cash flow concerns cash items only, and therefore excludes depreciation, which is not a cash expense. **Pre-tax cash flow**, or cash flow before taxation, is calculated as follows:

$$\begin{aligned}
 & \text{potential rental income} \\
 - & \text{vacancy and collection loss} \\
 = & \text{effective rental income} \\
 + & \text{other income} \\
 = & \text{gross operating income (GOI)} \\
 \\
 - & \text{operating expenses} \\
 - & \text{reserves} \\
 = & \text{net operating income (NOI)} \\
 - & \text{debt service} \\
 = & \text{pre-tax cash flow}
 \end{aligned}$$

Potential rental income is the annual amount that would be realized if the property is fully leased or rented at the scheduled rate. **Vacancy and collection loss** is rental income lost because of vacancies or tenants' failure to pay rent. **Effective rental income** is the potential income adjusted for these losses. To that is added any **other income** the property generates, such as from laundry or parking charges, to obtain **gross operating income**. **Operating expenses** paid by the landlord include such items as utilities and maintenance. These are deducted from gross operating income. Some owners also set aside a cash **reserve** each year to build up a fund for capital replacements in the future, for example, to replace a roof or a furnace. Cash reserves are not deductible for tax purposes until spent as deductible repairs or maintenance. The remainder is **net operating income (NOI)**. When the annual amount paid for **debt service**, including principal and interest, is subtracted, the remainder is the **pre-tax cash flow**.

For instance, a small office building of 3,500 square feet rents at \$20 per square foot. If fully rented, the annual rental income would be \$70,000. Historically, the property averages \$4,200 in vacancy and collection losses. Equipment rental will provide an additional \$2,000 per year in income. The owner will have to pay operating expenses amounting to ten dollars per square foot, or \$35,000 per year. The owner sets aside one dollar per square foot, or \$3,500 per year, for reserves. The owner financed the purchase of the building with a loan that requires annual debt service in the amount of \$20,000. The pre-tax cash flow for the building is illustrated in the following exhibit.

Exhibit 18.2 Pre-tax Cash Flow

	potential rental income	\$70,000
-	vacancy and collection loss	4,200
=	effective rental income	65,800
+	other income	2,000
=	gross operating income (GOI)	67,800
-	operating expenses	35,000
-	reserves	3,500
=	net operating income (NOI)	29,300
-	debt service	20,000
=	pre-tax cash flow	9,300

Tax liability

The owner's tax liability on taxable income from the property is based on *taxable income* rather than cash flow. Taxable income and tax liability are calculated as follows:

	net operating income (NOI)	
+	reserves	
-	interest expense	
-	cost recovery expense	
=	taxable income	
x	tax rate	
=	tax liability	

Taxable income is net operating income minus all allowable deductions. Cost recovery expense is allowed as a deduction, while allowances for reserves and

payments on loan principal payback are not allowed. Thus, since reserves were deducted from gross operating income to determine NOI, this amount must be added back in. As only the interest portion of debt service is deductible, the principal amount must be removed from the debt service payments and the *interest expense* deducted from NOI. Taxable income, multiplied by the owner's marginal tax bracket, gives the **tax liability**.

Note on tax rate: when a rental property is owned as an individual or by way of a pass-through entity (partnership, LLC treated as a partnership for tax purposes, or S corporation), its net income is taxed at the individual's personal marginal income tax rate. The next exhibit shows the tax liability for the previous example using an individual rate of 24%.

Exhibit 18.3 Tax Liability

	net operating income (NOI)	29,300
+	reserves	3,500
-	interest expense	10,000
-	cost recovery expense	22,000
=	taxable income	800
x	tax rate (24%)	
=	tax liability	192

After-tax cash flow

After-tax cash flow is the amount of income from the property that actually goes into the owner's pocket *after income tax is paid*. It is figured as:

	pre-tax cash flow
-	tax liability
=	after-tax cash flow

The after-tax cash flow for the sample property is illustrated in the following exhibit.

Exhibit 18.4 After-tax Cash Flow

	pre-tax cash flow	9,300
-	tax liability	192
=	after-tax cash flow	9,076

Investment performance

Investors measure the investment performance of an income property in many different ways, depending on their needs. A few of the common measures are:

$$\frac{\text{Net operating income}}{\text{price}} = \text{return on investment (ROI)}$$

$$\frac{\text{cash flow}}{\text{cash invested}} = \text{cash-on-cash return (C on C)}$$

$$\frac{\text{cash flow}}{\text{equity}} = \text{return on equity (ROE)}$$

Other measures of return use the process of **discounted cash flow analysis**. These methods, chief of which is probably **internal rate of return (IRR)**, require an estimate of projected after-tax proceeds from sale of the property. A licensee who does not have the expertise necessary for these more complicated measures should refer clients to a qualified investment expert.

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Real Estate Investment Snapshot Review

INVESTMENT FUNDAMENTALS

Investment characteristics

- the greater the risk, the higher the expected return
- some investments require more investor involvement than others
- some investments are more liquid (convertible to cash) than others

Rewards

- investors seek to increase wealth through income, appreciation, leverage and tax benefits

Risks

- risks: changes in supply and demand for the investment (market risk), changes in businesses with which the investment is connected (business risk), changes in the value of money (purchasing power risk), and changes in interest rates (financial risk)

Types of investments

- among the investor's choices are investments in money (e.g., certificates of deposit), equity (e.g., stocks), debt (e.g., bonds and mortgages), and real estate (income and non-income properties)

REAL ESTATE AS AN INVESTMENT

Risk and reward

- the real estate investor must weigh the potential risks and returns inherent in market variability, expected vs. real income, use of borrowing leverage, changes in tax treatment of capital gains and income, and the cost of capital

Illiquidity

- real estate is generally less liquid than other investment types: it takes time to market a property

Management requirements

- real estate tends to require more investor involvement than other investments do: maintenance, management, operation

REAL ESTATE INVESTMENT ENTITIES

Direct

- buying a property and taking responsibility for management and operation

Syndicate and partnership

- a group of investors pool resources to buy, develop and/or operate a property

Real Estate Investment Trust

- REIT: investors buy certificates in a trust that invests in mortgages or real estate and receive income according to shares owned

Real Estate Mortgage Investment Conduit

- REMIC: investors hold residual or regular interests in an entity that holds a pool of mortgages secured by real property

TAXATION OF REAL ESTATE INVESTMENTS

Taxable income

- gross income received minus allowable expenses, deductions and exclusions

Cost recovery

- deduction of a portion of a property's value from gross income each year over the

Gain on sale

- an excess of proceeds from sale of a property over the original cost of the property, subject to adjustments

Interest

- mortgage interest is deductible from annual gross income from a property, subject to limitations

Passive activities

- business activities in which the taxpayer does not materially participate, including interests in limited partnerships and rental activities; losses from such activities can be used to offset income from other passive activities

INVESTMENT ANALYSIS OF A RESIDENTIAL PROPERTY

- | | |
|----------------------------|--|
| Appreciation | <ul style="list-style-type: none">● increase in the value of an asset over time; may be stated as a difference between the original price and current market value, or as a percentage increase over the original price; not a true measure of investment return |
| Deductibles | <ul style="list-style-type: none">● for non-income properties, primary tax benefit is annual deduction for mortgage |
| Tax liability | <ul style="list-style-type: none">● the seller of a principle residence owes tax on any capital gain that results from the sale unless excluded; capital gain is defined as the amount realized minus the adjusted basis |
| Gains tax exclusion | <ul style="list-style-type: none">● up to \$250,000 for a single seller and \$500,000 for a married couple can be excluded from gains tax every two years |

INVESTMENT ANALYSIS OF AN INCOME PROPERTY

- | | |
|-------------------------------|--|
| Pre-tax cash flow | <ul style="list-style-type: none">● annual pre-tax cash flow is net operating income minus debt service |
| Tax liability | <ul style="list-style-type: none">● tax liability on income from a property is based on taxable income: net operating income minus interest expense and cost recovery |
| After-tax cash flow | <ul style="list-style-type: none">● annual after-tax cash flow is pre-tax cash flow minus tax liability |
| Investment performance | <ul style="list-style-type: none">● a few common measures of investment performance are:<ul style="list-style-type: none">- return on investment (net operating income divided by price)- cash-on-cash return (cash flow divided by cash invested)- return on equity (cash flow divided by equity)- discounted cash flow analysis- internal rate of return |