

Real Estate *advisor*

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Real estate and leveraging: The risk of taking on too much

Leveraging other people's money has always been a primary tool for real estate investors. Using leverage, savvy investors have been able to make more money, much more quickly than they could have otherwise. Leverage can be used to increase cash flow, magnify the effects of property appreciation, and enhance the tax advantages of owning real estate.

Although there are advantages to using leverage, there's also increased risk of loss. Market declines, coupled with interest rate fluctuations, can result in negative cash flow and even affect the fundamental value of the property investment.

Despite the downturn in easily available funds, banks continue to loan. They're still doing business, and even with tighter lending rules it's still possible to become overleveraged in your real estate ventures.

Leverage when lenders are tight

Although the long-term effect of the U.S. credit crunch has yet to play out, banks have definitely tightened their loan requirements. Lenders that previously asked investors with good credit ratings for 20% to 30% down are now asking for 40% to 50% on some real estate deals.

Because many loans are based on fair market value (FMV) and the FMVs of most properties have dropped, investors have less to borrow against. Lower property appraisals, combined with the tightening of loan-to-value (LTV) ratios, has made cash much harder to come by.

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How much is too much?

Small differences in personal circumstances and preferences can lead to very different investing choices — there's no “right amount” of leverage to use. But while each investor may have a different situation and risk tolerance, there are limits to the amount of leverage that should be applied.

Overleverage in the residential real estate market (where some banks were loaning at LTV ratios of 105%) and the failure of banks to maintain adequate cash reserves are two of the biggest contributing factors



of the current credit crisis. Investors who wish to maximize profits through leverage shouldn't repeat those mistakes.

One method for determining an appropriate leverage is to apply a "stress test" to cash flow projections for a property. For example, what would happen if your vacancy rate jumped to two to three times its normal level (such as 10% to 15% instead of 5%)? What would happen if you had to lower the rental rate by 5% to 10% or make significant concessions just to attract new tenants? Would the property still have sufficient positive cash flow to cover a worst-case scenario for a year? If not, would you have enough cash in the bank to survive?

Red flags

The fact that a bank won't approve a traditional loan for your latest investment may be just the result of today's conservative banking environment. On the other hand, it could also be a "red flag."

If the only type of financing available to you is "exotic" or "extremely creative," it may be time to reconsider whether you might be overleveraged. Two examples of financing which frequently involve overleveraging include:

1. Recourse loans with terms that are particularly unfavorable to the investor, and
2. Wrap notes. A wrap note is essentially a seller note that provides additional leverage to cover the full cost of the transaction — leveraging the costs not covered by the conventional bank debt. It wraps around the total project cost to include funds that provide resources to cover debt service on the primary note for some period of time, pushing the aggregate LTV in excess of 1:1.

The safest strategy is to never leverage a property beyond the zero-cash-flow breakeven point. In other words, plan your investments so that, even if occupancy rates are down, cash flow will cover the property expenses, including debt and a reserve for major repairs, but excluding depreciation. This way, you won't have to dip into cash reserves to meet the operating expenses of an investment that's teetering on the brink of negative cash flow.

A common rule of thumb in today's credit environment is 60% to 65% LTV. This ratio is considered

What is the LTV ratio and why does it matter?

The loan-to-value ratio (LTV) is calculated by dividing your outstanding mortgage balance by the appraised property value. The higher the equity, the lower the LTV ratio will be, and the lower the LTV, the better the mortgage interest rate.

A higher LTV means more risk to the lender. This risk is passed to you, the borrower, in the form of higher interest rates, increased lending fees or expensive private mortgage insurance (which protects the lender from losses due to foreclosure but also drives up the monthly payments).

Most lenders allow a maximum of 75% of appraised value or a 75% LTV ratio for new mortgage loans (though you should keep in mind that LTVs at this level generally aren't easy to achieve in the current debt market). Lenders that finance or refinance at LTVs at or greater than 75% will usually charge less favorable interest rates and terms.



a conservative measure to go by. Such an LTV will provide you with the advantages of leverage without putting cash flow or reserves at excessive risk and thereby making the quest to achieve debt less difficult.

Leveraging in a down market

With the current increase in availability of affordable properties, investors may feel tempted to extend their portfolio by purchasing as many of these properties as possible. Leverage really works best when property values rise, however. Given today's real estate scenario, savvy investors should calculate carefully and proceed with caution when using the powerful — but dangerous — tool of financial leverage. ■

Perils and pitfalls abound

Selling investment property to your offspring

A perennial challenge for real estate investors is how to transfer property to their heirs in the most tax-advantaged way while also maintaining control of the property and its income stream. The IRS pays special attention to transactions among family members and generally assumes that any transfer among them is really a gift. Whether a transfer is considered a gift or a sale can have significant tax consequences for both parties involved.

When a sale is really a gift

Some families choose to “sell” property to a child at market value and accept a note, secured by a deed of trust, for the full sale price.

Using this strategy, the child undertakes a monthly payment and enjoys a stepped-up basis in the property (from that of the parent). The note can be forgiven at some future date, or dissolved upon the death of the parent(s). If the child doesn’t have enough cash to make the monthly or quarterly interest payments, the parent could gift them the cash. Although this strategy sounds appealing, it has certain risks.

When property is gifted to a child, the donor’s tax basis becomes the tax basis of the recipient. A lower basis

means less depreciation for the child over the life of the property, and a higher gain upon disposition or sale.

Properties that are sold, on the other hand, can result in a higher basis for the child, more tax-saving depreciation expense over the life of the property, and less capital gain in the event of a sale, not to mention capital gain to the seller. As a result of the IRS’s “family transfers are usually a gift” presumption and the tax consequences involved, selling appreciated real estate to children shouldn’t be attempted without careful planning.

In addition, the IRS has strongly held that a loan that includes a prearranged plan for future forgiveness isn’t really a loan, but a gift. The fact that the child has a loan (on paper) for the price of the business doesn’t soften this interpretation. When Uncle Sam audits a transfer that was intended to be a loan and then reclassifies it as a gift, the value of the loan is considered “given” in the initial year of the transaction. At the same time, the child’s basis in the property becomes the same as the parent’s, rather than the purchase price it was intended to be.

Avoiding tax tangles

There are potentially dire consequences of reclassifying a sales transaction, including an almost foregone conclusion that canceling a note between family members is prearranged. This situation has left many real estate owners wondering if there’s a way to sell property to their children while avoiding potential tax tangles.

The answer to this question, while not always easy, depends on the specifics of your situation. If you wish to transfer property to your children through a legitimate, IRS-recognized sale, you should avoid “announcing” at the time of sale that the debt will someday be canceled. Make sure you document the sale and treat it as a true business transaction.

Establishing an interest rate that’s not lower than the IRS’s current applicable federal rate and structuring the loan as “on demand” will also help you establish the sale as a bona fide business transaction. Whether



interest payments are made monthly, quarterly or once a year isn't as important as the fact that they are made on a regular basis. And you need to treat the transaction as an "arm's length" transaction. In other words, as odd as it may seem, you need to treat your child like a stranger for purposes of the deal.

Finally, make sure the promissory note is secured by a deed of trust on the property being sold. Otherwise, your offspring won't be able to deduct the mortgage interest they pay you. If the thought of asking your children to make interest payments to you makes you uncomfortable, consider gifting the money to them.

You can give each of your children up to \$13,000 in 2009 (\$26,000 if both you and your spouse make the gift), which they can use to make the interest payments to you.

Keep an eye on the IRS

No matter how you structure transactions when selling investment property to your offspring, there will always be some risk involved. But the more the sale looks like a legitimate transaction (rather than prearranged), the better your chances will be in the event of an IRS audit. ■

The tax effect of a lease with option to buy

Many real estate professionals use the "lease with option to buy" method of structuring deals, because it enables them to collect higher monthly payments and higher prices overall than they could in a normal transaction. Lease options bring buyers to the table that otherwise wouldn't have been able to purchase, thus enabling sellers to move houses in a down market.

But, as popular as this method is, both lessees and lessors need to be aware of certain tax implications. If the deal isn't properly structured, the IRS may conclude that an ownership transfer took place at the beginning, rather than the end, of the lease.

Signals of a sale

If a lease is structured with such high financial incentives to exercise the option that the tenant is economically compelled to buy, the IRS may see a red flag and recharacterize the lease as a sale. Other characteristics that signal a sale to the IRS include:

- Lease payments that are substantially more than the actual fair market rental rate of the property or that appear to be "interest in disguise" — the monthly lease payments are close to what they would have been had the agreement been a mortgage instead,

- Lease and option payments that, in total over the life of the lease, approach the fair market value of the property in question,
- Terms that require the tenant to make such substantial improvements to the property that investment can only be recovered if the option is exercised,
- Terms that credit lease payments against the option price, and
- Terms that offer too much of a "bargain purchase price" at the end of the lease.

The fact that the lease option price is a bargain doesn't, by itself, mean the lease was really a sale.

In making lease-sale determinations, the IRS looks at all the factors involved. If the lease payments reflect market value and aren't applied to the purchase price, and if the option price is a substantial part of the property's fair market value, the transaction may still be characterized as a lease. Even if lease terms (including monthly payments and the buyout amount) weren't at fair market value, the IRS considers whether the parties involved believed in good faith that they were.

The cost of recharacterization

An IRS determination that a lease was really a sale alters the timing of the transaction, resulting in significant tax consequences for both parties involved. In such cases, property ownership is assumed to have transferred at the inception of the lease. The tenant loses the lease deduction, but is allowed to deduct depreciation and other operating expenses related to the property.

Part of the lease payments will be deductible as mortgage interest — which will be calculated under the “imputed interest rules.” The remaining portion of the payments will be considered as part of the property’s purchase price in computing a new tax basis for the property.

For the landlord-turned-seller, the sale is treated as an installment sale, with what would have been the option payment now serving as a down payment. As in the case of the tenant, a portion of lease payments

is allocated to interest and a portion to the selling price. Most important, part of the installment payment becomes long-term capital gain or ordinary loss to the seller (if the property was held for more than a year and the seller wasn’t a “dealer” in real estate).

The net result for the landlord-seller is to convert ordinary income (rent) into capital gain or ordinary loss (based on proceeds from the sale). The seller’s applicable tax rate could be lower as a result, though any benefit could easily be offset by the loss of depreciation and operating expense deductions.

Sorting through the maze

Although the lease option is a valuable strategy in many situations, a number of tax planning issues are involved. To protect against recharacterization as a sale, make sure your next deal is structured carefully and uses rental and property values determined by qualified experts. ■

How to spot a bad apple when screening tenants

Screening out troublesome tenants is a critical task for any landlord. By eliminating the bad apples before they move in, you can avoid many aggravating problems that may arise after they’re settled in. The key is to implement a smart screening process and stick to it.

Screening begins when you first place the ad. What type of tenant do you *not* want? Smokers, large families, people with pets? Make your expectations clear. If you require references and/or a credit check, state that as well.

While you want to attract prospective tenants, you also want to deter those you don’t want to see. Base your criteria on legitimate business concerns, staying within the limits of fair housing regulation and antidiscrimination laws. Discriminating on the basis of race, religion, national origin, gender, age, familial status or disability is unlawful. In addition, many localities prohibit discrimination based on marital status, sexual orientation or family size.

Your second shot at smart tenant screening comes during the initial conversation. This is an excellent opportunity to ask qualifying questions. Be wary of prospects who struggle to answer or seem annoyed at being asked. Other warning signs include showing up late (or not at all) for appointments, a sloppy appearance or a seeming lack of respect toward the property.

Have on hand a written application that documents the tenant’s understanding of the property rules, regulations and lease, and provides space for tenant references and personal information. Not only will this information help you evaluate the character and fiscal solvency of the individual, but it can also help you locate the tenant should he or she abscond later on.

Tell prospective tenants that their applications will be considered along with others. Never approve a tenant without a reference and credit check. If you choose not to take a prospective tenant and later face litigation because of that decision, you’ll need to provide factual, antidiscriminatory reasons as to why he or she didn’t qualify in your legal defense.

In addition to weeding out bad tenants, careful screening practices will help you document the process and decision, saving you trouble later if a tenant turns out to be a bad apple.

Ask the Advisor

Is multifamily housing a smart investment in today's market?

The stock market volatility last fall convinced many investors that it was time to allocate a larger segment of their portfolios to real estate investments — particularly multifamily housing. Although its rate of return is generally lower than that of real estate ventures, it's considered a less risky, more stable investment within the real estate sector. That's because, even though businesses may fold in difficult times, people will always need a place to live.

The multifamily housing real estate segment isn't without its concerns, however. Layoffs in the job market will have both a positive and negative impact on demand for apartments. On the one hand, if laid-off homeowners fall into foreclosure, they'll likely turn to apartment dwelling as a cheaper alternative.

On the other, if the layoffs continue, some tenant fallout is to be expected. High-end apartment complexes, which are likely to feel the greatest impact, might have to make

rent concessions to maintain high occupancy levels. And tenants who lose their jobs or are worried about job security may opt to move in with family or rent smaller and, thus, less expensive apartments.

Multifamily housing demand will also continue to be affected by cycles in the single-family home market. When the market for single-family homes is depressed, speculative investors often opt to rent their homes rather than sell them. A glut of rental homes entering the market competes with apartment rentals, resulting in higher vacancy levels and lower rents for multifamily housing.

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Despite these possible gloom-and-doom scenarios, multifamily housing remains a viable real estate investment option. The tax benefits associated with real estate investing in general (such as the potential for tax sheltered cash flow and long-term capital gains treatment upon disposition), when combined with the federal low-income housing tax credit or other incentives, boost its appeal.

Tax benefits, appreciation in property value and cash flow can vary widely depending on your particular situation and the specifics of the real estate investment involved. When evaluating your options, seek the advice of a professional real estate advisor who can prepare detailed projections of the economic impact of the investment on your bottom line to help guide you to the right decision.

Although multifamily housing can be an advantageous investment in sour economic times, make sure you stick to sound investment principles. Carefully watch market trends when buying property — whether the property involved is multifamily, retail, office or land. ■

In the real estate industry, the numbers are big and so are the risks. Poor timing, bad advice, even small oversights can have substantial consequences. Whether you're a developer or an investor, Elliott Davis' Real Estate Practice helps keep your business grounded.

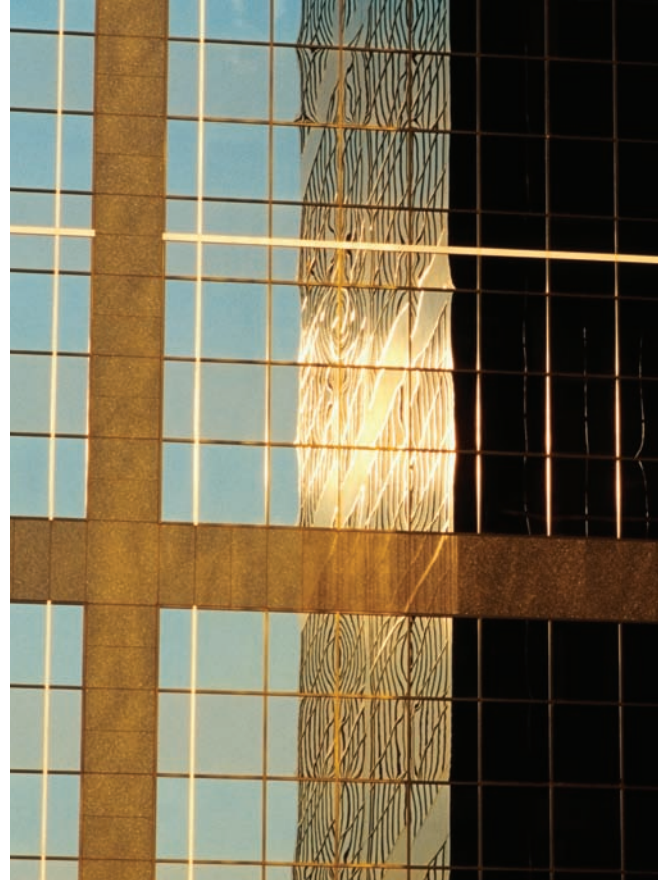
Our team puts its deep industry knowledge and experience to work for you with customized solutions based on your specific situation and requirements. With our network of locations throughout the Southeast we deliver personalized service wherever your business lands.

ACCOUNTING SERVICES:

Our team reviews your historical financial statements, evaluates trends, pinpoints strengths and weaknesses in your financial and operational business performance, and makes certain you're receiving the right kind of financial information to run your business and ensure tax compliance. We provide not only traditional credit, review compilation, and tax preparation services but also forecasts, projections and acquisition evaluation and accounting.

BUSINESS ADVISORY SERVICES:

Our Real Estate practice helps you consider and structure various alternatives to maximize return on investment. A sampling of our services include: 1031 exchange consulting, cost segregation studies, revenue recognition and cost allocation techniques, tax credits, and business entity planning and organization choice.



With offices located throughout the Southeast, members of the Elliott Davis Real Estate Practice can respond quickly to their clients' needs. Please contact us at 1-877-340-6802 to tell us your real estate goals and learn how we can help you achieve those goals, or visit us online at www.elliottdavis.com for more information.

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