

JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS
II. CLASSES AT THE UNIVERSITY OF WISCONSIN--MADISON
L. Business 850: Real Estate Equity Investment
5. Student Projects and Problem Sets
b. Student abstracts from assigned readings

ABSTRACT OF WED., JAN 2, READING F

Title: The Next American Frontier, Robert Reich, Atlantic monthly

Prepared by Kevin Coffey

Summary: If Americas' industry is to halt its decline in the world marketplace, it must change its orientation from high volume production and paper profits to a "flexible system of production", which emphasizes skilled teams of employees and concentrates on productivity increases.

I. THE END OF AMERICA'S "MANAGEMENT ERA"

-Between 1920 & 1970 American industry was characterized by high volume, scientifically managed tasks which produced standardized goods and generated vast economies of scale

-Since 1970 America has suffered a decline in its share of the world marketplace

-this decline has resulted as many of the world's developing countries began to specialize in capital intensive production

-result of above: American industries are becoming uncompetitive in the world market

II. AMERICA MUST SHIFT ITS INDUSTRIAL BASE TOWARDS PRODUCTS AND PROCESSES THAT REQUIRE SKILLED WORKERS

-skilled labor is the only dimension of production where America retains an advantage over developing nations

-traditionally separate business functions must be merged into a highly integrated system of skilled workers that can respond quickly to new opportunities, a "flexible system of production"

III. THE TRANSITION TO SUCH A FLEXIBLE SYSTEM WILL REQUIRE A BASIC RESTRUCTURING OF BUSINESS, LABOR & GOVERNMENT

-relationships between the above three entities must become less rigidly delineated

-businesses must concentrate on **improving productivity** to increase earnings rather than through "paper entrepreneurialism" ploys designed to increase earnings without investment

example: companies conglomerate not to bring new skills to the organization, but rather to generate huge paper profits through manipulation of accounting and tax rules

IV. CONCLUSION

-Paper entrepreneurialism is both the cause and consequence of America's faltering economy. It has retarded the transition that must occur, and made change more difficult in the future. It is a self-perpetuating quality that, if left unchecked, will drive the nation into further decline.

Elaine Worzala
2/25 E 850

Chapter XIX "Estate Tax--Deductions, Expenses, and Losses"
Federal Estate and Gift Taxation by Briner, Robison, Rossen and Sogg-1982

The article goes through the specific deductions allowed from the estate tax of a decedent. These include funeral expenses, administration expenses, claims against the estate, unpaid mortgages, and casualty and theft loss. All of these categories are pretty much self explanatory and the chapter simply goes through each one. Highlights of the chapter are:

Expense Deductions:

Claims against the estate cannot be greater than the value of the property in the estate, and the deductions must relate to a bona fide obligation. The only exception is donations to charities. "Expenses must be actually and necessarily incurred". A lot of litigation is over the exact meaning of this phrase.

Funeral expense: only deductible if expended, money is there, local law agrees. Just what you would expect.

Administration expense: actually and necessarily incurred. Law allows for expenses not yet paid as long as an estimate can be made.

Claims against the Estate: must represent payments for legally enforceable obligations which exist at the time of death. Must have had adequate consideration.

Unpaid mortgage: For this to be deductible the total value of the property undiminished by the mortgage must be part of the estate.

Taxes: No deduction for income received after death or property tax accrued. To be deducted they must qualify under another deduction.

Losses: Allowed for losses in settlement, disaster or theft. Estate cannot have been compensated by insurance and generally will have to be from an event sudden in nature.

Deduction from Estate or income tax: administration expenses and losses
medical expenses paid within 1 year

Must file a statement and sign a waiver stating you are deducting from income rather than estate. This is an irrevocable decision.

VI. Estate Tax Credits:

A. State death tax credit allowed for any US or District of Columbia citizen though it is not allowed if it was an expense deduction, paid with respect to another descendants estate. Only amount paid can be credited

Adjusted taxable estate= Gross estate - deductions - \$60,000 and if this is less than \$40,000 no credit can be taken. An outdated tax table (1976) is on pg. 367 There is a time limitation of 4 years and proof of payment is required to get the credit.

B. Gift tax was established to prevent avoidance of the estatetax by making intervivos transfers and to avoid double taxation. It is allowed for gifts made form the estate--not made in the life of the doner. If interested the computation for the cift tax credit is on pg.369

C. Foreign Death tax the estate of a nonresident alien is not entitled to the credit and relief of double taxation must come form the foreign country. There are a few countries where treaties exist. Check with a lawyer

D. Credit for prior transfer when estate taxes were paid for another person's death. This credit is allowed if the property was transferred and the person died within 2 years after or 10 years before and a federal death tax was paid. For formula and table see pg. 373.

Chapter XX Estate Tax--Charitable Deductions and Credits
Federal Estate and Gift Taxation by Briner, Robison, Rossen and Sogg-1982

This article is not actually on the syllabus, and has little relevance to this class. As the other ones, it goes through the specific items that are deductible or credits from one's estate tax. A deduction is allowed on bequests for public, religious, charitable, scientific, literacy, and other educational purposes. The amount may not exceed the value of the estate and must be made to a qualified charitable organization for a qualified purpose. The organization must have a tax exempt status.

I. Transfer requirements: Must be during lifetime or by will
A transfer will not qualify if the property escheats to the state, property which passes as a contractual arrangement (a priest has taken a vow of poverty so all worldly goods go to the church), or it passes through the act of a noncharitable person.

II. Special Rules: No deduction if the bequest is contingent. If it rests on the occurrence of an event the chance of the charity not receiving the money must be remote possibility < 5%.

III. Split interest and remainder interest: A split interest occurs when a person leaves an interest in the same property to two people. Usually leave the life estate or income interest to one individual and a remainder interest to the other. If one is a charitable organization the following rules apply.

If it is an income interest it must be either a guaranteed annuity interest or unitrust interest that is defined as the right to receive a fixed percentage of the annual fair market value of the property.

If the bequest is a remainder interest and someone other than the charity has an intervening interest (a life estate) the deduction will be allowed if the remainder interest is in the form of a remainder annuity trust, a pooled income fund, or a nontrust remainder interest in a personal residence or farm.

IV. Income Interest: Occurs when someone else is entitled to the remainder interest. The interest income must be in the form of a guaranteed annuity interest or a unitrust interest. Deductions are allowed if the guaranteed annuity is a stated sum or a fixed percentage of the fairmarket value and cannot fluctuate. If it is a unitrust the interest must be paid once a year and the FMV will include all assets and liabilities that fund the trust. If the interest is not in a trust the amount will be deductible only if paid by an insurance organization or a company of similar nature making periodic payments.

V. Charitable Lead Trusts: Donated property in which the charitable organization will receive an annually fixed dollar amount, guaranteed annuity or a fixed percentage of FMV (unitrust). When the charitable lead expires the property often reverts to noncharitable beneficiaries.

The lead interest is valued at 6% which could be advantageous if the return on investment exceeds 6%. (Example on page 359)

This technique is used primarily by wealthy individuals.

Taxes Due on Sale Chapter 10
Tax Planning for Real Estate Investors
Kau and Sirmans (1982)

The article details the various tax impacts of investment properties or for purchases for use in business or trade. Most Real Estate is considered as a use for business or trade. The law state that any sale is a taxable transaction and one must recognize the gain or loss. The author goes through three areas--deprecaition recapture, capital gains and losses and minimum taxes--of which he feels the most important is cap gains.

- I. Ordinary income taxes on depreciation recapture (only with 175%):
residential: use only excess depreciation (total amount that would have been taken with straight-line) is subject to recapture
non-residential: if accumulated depreciation was used then all accumulated accelerated depreciation used must be recaptured and is subject to ordinary income tax.

Adjusted Basis:=(Original Cost)+(cap. improvement)-(cumul. depreciation)
(Gain/loss)=(amount realized)-(adjusted basis)
(Capital Gain/Loss)=(gain/loss)-(excess deprciation from S/L)
Adjusted Basis for a partnership with special allocations is determined by:

(Equity)+(assessment)+(share taxable income)-(share loss)-(share BTCF)

II. Long term capital gains: property held more than one year and is taxed at the cap gain rate. Noncorporate taxpayer uses a 40% rate for cap gain and a net loss is deducted in full from other taxable income with the following restrictions: limit of \$3000, short term is deducted \$ for \$, while long term only 50% is deductible.
Short term capital gain are taxed as ordinary income.

If there is both gains and losses they must be netted by long term and short term.

A corporation follows different rules. Capital losses are not deducted and the full amount of cap gains is used though usually at a lower rate. They can also carry cap losses back for three years and forward for five. The configuration of the taxes are complicated and I would suggest a CPA. Also see pg. 153.

Section 1231 property gain or loss: Most of the real estate falls in this category as it must be held for over one year and the investment must be for trade or business. These properties are not capital assets. Residential income properties, for example.

To figure the gain/loss aggregate the gains and losses. If net gain it is taxable as a capital gain and if it is a net loss it is fully deductible. The excess depreciation is taxed as ordinary income.

How to Evaluate (or Structure) an RE Investment
By Davidoff and Anderson October '84

This article is written from the accountants point of view and explores the many considerations, tax and nontax, involved with evaluating or structuring real estate. The article considers the obvious in terms of reviewing the people involved with the project and the economics of the project, and then it gets into detail on the tax considerations, which is probably why the article was assigned so I will concentrate on this.

I. Tax Consideration

A. Overall Tax Approach: Are the tax assumptions valid and reasonable? Is the tax structure realistic? Answering these questions first will throw out many of the potential syndications currently on the market.

B. Tax write-off: In many cases the size of the write-off is stressed more than the viability which should be an immediate clue. The authors stress that solvency must be there without the funds of the investor and then the write-off can be determined. The average tax-sheltered invst. will have between a 1.25:1 (for a very economic deal dependant on cash flow and appreciation) to 2.25:1 (A more tax concentrated return.)

C. Depreciation (ARCS): A major consideration in the structure of the deal as it is a noncash-flow deduction. Deductions are determined by:

1. The tax basis in property: (debt liability) + (cost)
2. Allocation of basis between:
 - Land (18 years)
 - Real property (18 years)
 - Personal property (5)

Personal property will serve the interests of the client best but the allocation can be tricky with the majority in real property.

D. Cost Recovery Methods:

1. Real property: 18 years using 175% declining-balance. low income housing appears to be the only one left at 15 years and 200%
2. Personal property: 5 years using 150% decining depreciation.
3. Caution for tax-exempt entities as straight-line must be used and a period up to 40 years.
4. Don't forget about the recapture rules in which a) all deduction recaptured to the amount of gain for personal property, invst. held for less than a year, and non residential real property if accelerated depreciation was used will be taxed as ordinary income. b) Excess depreciation up to the gain for residential real property using accl't depreciation and held for over one year will also be taxed as ordinary income.

Advantages of Straight-line:

1. Avoid recap. on non-residential RE specially if looking for a profit on resale. Use accl't if in high tax in entering the invstmt and low on resale or if planning to pass on a stepped up basis on death.
2. Minimize exposure to the alternative minimu tax(AMT): The Amt is a creature and is determined as follows:

Mini tax

Alternative minimum taxable income(amt)=
 Gross income
 plus Tax preferences
 minus alternative tax NOI loss deductions
 minus Alternative item deductions
 minus amounts distributed by a trust(section 667)
 AMTI

The AMT = .20(AMTI)

The tax due is the greater of the AMT or ones income tax.

Tax preference itams include:

1. Excess depreciation if partnership had used straight-line(SL)
2. Leased personal property excess if had used SL over 8 yrs.
3. Net capital gain deductions on long term capital gain.

D. Interest deductions: Major reason for many invstmts.

Limitations: Can't deduct prepaid interest and if points are involved they must be spread over the term of the loan.

Can deduct accrued interest only if accrued interest and the loan balance equal fair market value

Most Re invstmts do not qualify for invstmt interest though if the client owns and leases the property these two conditions may put him/her under the invstmt int. rules: Section 162 deductions don't exceed 15% or the client is guaranteed a specified return or guaranteed against loss.

Generally interest paid to other parties is allowed though the IRS can come in and reallocate if 2 or more trades are owned by the same interests, so you have to be careful.

For imputed interest and exceptin to the 10% installment cap is on land which does not exceed a payment of \$500,000 in which it is a 7% cap. Rules to be followed as of 1/85 are the original discount rules (DID) which you should see your tax lawyer about.

Construction Interest is no longer completely deductible during the construction phase but must be amortized over a ten year period. Only exception is subsidized housing.

Still in uncertain water is the wrap-around interest though it is under question. The limited partners should be sure to reserve the right to approve any sale as this may become a very sticky issue.

E. Investment Tax Credits: One can have 10% on a variety of things but none of them are relevant to RE, in general, except property used for nonlodging commercial use open to the public (a restaurant), rehab for certified historic structures and other commercial buildings.

D. Syndication and Nonoperating Costs: Tax treatment varies. current services are currently deductible

organizational work is amortized over 60 months

acquisition of the RE must be added to the basis, recover thru ACRS deductions.

Expenditures for issuance and marketing is non deductible until termination of the partnership.

Acquisition of Financing is amortized over the term of the loan.

- F. Partnership Consideration: Must be aware of the following:
1. Recognition of the venture as a partnership should get an opinion by a counsel that the IRS will see it as a partnership
 2. Must make sure that any special allocations have substantial economic benefit. Make sure that the capital accounts zero out. Better also make sure the regulations in Section 704(b) are followed.
- F. Property Disposition: Compute the gain on sale and then allocate the gain in accordance with the agreement.
- Gain allocable to land is capital gain
 - Gain on tangible personal property is recaptured as ordinary income to the extent of original cost.
 - Gain allocable to real property is one or the other depending on dep. method and type of property.

As of 1984 all depreciation must be recapped in the year of sale regardless of the amount of income recognized by the installment sales rule. As far as actual allocation, there are no hard and fast rules, but they should be set in the agreement and should be structured with the people involved, the economics of the deal, and the tax positions all in mind at the onset.

Inflation and the Real Estate Investor
The Appraisal Journal
By Paul Wendt (1977)

The article examines the impacts of inflation on existing improvements vs. new developments and at the effects of inflation on the different types of investors as well as different types of properties. It reviews trends from 1966-1976 so it is slightly outdated.

I. Existing Properties

In most cases this is a good hedge as there is no question on refinancing or increasing costs. However, must make sure leases are structured to allow for inflation. As far as expenses, it depends on the rate of inc. in relation to NOI.

II. New Properties

Dangerous during times of inflation as the increases in construction costs and finance costs could kill the project. Also, cap rates usually fall during times of inflation causing values to decrease.

III. Unimproved land

Very adverse short run effects due to the effect of increased construction costs and financing cost causing land values to decrease sharply. Exceptions to this general principle include Agriculture and forest land as the products of this type of land use will increase causing an increase in income.

The adverse effect on unimproved land and new properties also indirectly effects the existing properties as it strengthens the market, thus demand.

IV. Effect on different types of properties

A. Shopping centers are good hedges as they usually have clauses in the long term leases. Furthermore, products sold are increasing in price and rents are often tied to gross sales increasing income from the center. On the otherhand, residential income properties are often poor hedges, especially if they are subject to rent control (New York City)

B. Author refers to the homebuyer as a super hedge if inflation occurs after the home has been bought with a mortgage. In this case the homebuyer is getting money at a cheaper rate than the lenders cost of funds. This is what has put the financial instit. into such a mess at this current time.

C. the multifamily residential investment will also be a good hedge if it is located in a large metro with construction costs of the '60s. The increase in construction costs and financing has deferred construction of new units, resulting in inc. demand for existing complexes, decreasing vacancy and increasing value. --

Elaine Worzala
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The Coming Entrepreneurial Revolution: A survey
Norman Macrae of the Economist 12/76

As most of the earlier articles this one is a bit off the wall. The author feels that the methods of operations will shift in the next decades and suggests ten ways this might occur from the businessmen's point of view, rather than government.

I. Ten potential changes:

- A. Big business is out
- B. State capitalism is also on its way out
- C. The decision blocking power of bureaucracy will disappear
- D. Top down management is not as successful due to better educated workers and a move from automation to brain power in the service and hi tech industries.
- E. The incentives to keeping workers happy will become more personalized.
- F. The entrepreneur will become more and more important as custom design will become more important but still have to be done at a mass production price.
- G. Suggests that the successful corporations should attempt to dissolve into confederations of entrepreneurs to successfully compete with all of the new technologies.
- H. It appears that ownership is no longer equated with control and may in fact result in powerlessness. Due mostly to the many levels of management in the larger corporations.
- I. The author predicts that the management of large corporation and small ones will rotate back and forth between centralized and decentralized. He feels this will keep the organizations on their toes.

The rest of the article expounds on these ten points. The purpose of the article is to elicit response and is basically just food for thought. As it was written in 1976 I don't think it is super important. The major points stressed beyond the ten predictions are that entrepreneurs and their unique way of thinking and creating innovative ideas is what the business world is moving back to but it will occur slowly over time in three steps:

1. The working class will move away from being a socialist and more towards the right-wing (this is written by a Brit) which is already happening--
2. Big business, however will not be the winner as the bureaucracy is becoming too difficult to deal with and no one likes red tape.
3. Finally, first the private sector will have to reorganize to an entrepreneur mode before the large government bureaucracy will go.

Chief's suggestion that the copy center would be much more productive if it were under private ownership seems to parallel the general gist of this article and will probably be the only thing he might test on.

How to structure Real Estate investment management

By: Stephen Roulac (1981)

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Elaine Worzala

lots of expertise

The focus of this article is to examine the economies of real estate management process to provide guidelines for designing compensation arrangements. It analyzes the three steps of property level investment: acquisition, portfolio management and property disposition, and recommends various ways of compensation strongly recommending the modern investment management structure.

I. Types of compensation

A. The custodial method: fixed annual fee, calculated as a percentage of invested capital--i.e. a salary such as is paid in a bank or insurance company.

B. The front end investment fee: as in the title it involves substantial compensation for the investment manager, as a broker. He would be paid with minimal cash during the management or property disposition, unless superior work is done. Typical for public real estate securities.

C. The modern investment management structure: What the author recommends which consists of treating the goals as both an investment and management problem, compensating for all three levels of participation. It is an attempt to match compensation with the needs of real estate investment; that is, fairly high front end costs, average maintenance costs and high amounts of dollars at sale, unlike the needs of corporate investment which requires no maintenance and different people do the buying and selling.

Overall a pretty simplistic article without too much relevance unless you are in charge of compensating your portfolio managers and if that is the case, I also suggest the third way.

Institutional Strategies for RE Equity Investment
By: John McMahan
no date

The article is written by the president of a real estate investment advisory firm that actively seeks investment portfolios for pension funds. The article explores the nature of RE as an investment, the different invstmt vehicles, strategies for developing a portfolio, and finally how to set up a real estate invstmt program for ones portfoli.

I. Nature of Real Estate as compared to securities

1. The decision to invest is difficult due to the lack of reliable information, the lack of sophisticated investors that have been well trained (unlike the UW grads), lack of measurement.
2. The transaction is both difficult and time consuming with the good potential of involving high legal fees. It is also less regulated so the caveat emptor may be important to the unwary investor.
3. Investment performance: Historical trends, though not extremely accurate, have shown that RE has at least comparable returns with equities and during times of inflation has superior performance, due to the hedging. There is some indication that it is alot less Volatile than equity due primarily to the type of invstmt--i.e. most institutions will invest in commercial properties in which rent, the income stream, is an obligation to the business and will always be paid. Finally, liquidity is the weak point of RE.

II. Investment Vehicles

1. Common Stock in an RE firm: very similar to investing in the stock market. Major drawback is that these firms are highly cyclical in which the performance of the stock is influenced by the business cycle, monetary policy, cost of raw materials and other externalities
2. REIT: Generally these provide diversification and liquidity. subject to economic swings. Major problem is their poor past (1st Wisconsin)
3. Syndications: less liquid and diversified. Major problem is they are aimed at small investors for tax writeoff. They also typically require a heavy front-end loading/riskier.
4. Open-End Funds: Percieved to offer liquidity and diversification and the cash flow and appreciation benefits of RE. National in scope (diversification) and often come with some type of redemption agreement (liquidity). Major criticism: the value is determined by an appraisal and we know from 856 (oops some of us didn't take that class!) that appraisals often differ due to:
 - a. the variations in qualifications of the appraiser,
 - b. local and regional market conditions
 - c. different techniques used to value the property.
5. Closed End Funds: smaller with a specified maximum not as diversified and the liquidity problem is greater
6. Separately Managed Funds: use an internal staff or and advisor advantage is the potentail for custom design to meet objectives

have control over the make-up of the portfolio and its quality.
The disadvantage is the time it takes to build and manage

III. Strategic Considerations

A. Resource Allocation--suggests 10-30% of the total portfolio

B. Risk Diversification

1. Geographic: loss as a result of natural disaster, a major deterioration in the local economy, or an adverse regulatory environment.

2. Product Diversification

3. Lease Diversification in terms of credit and term

4. Size of the portfolio: if < \$80 million should invest only in pooled funds. If > \$80 M may want to go to separate management for greater control and better long term performance.

Should have at least six properties (\$24 M) for diversification

5. Leverage: the core of the property should be unleveraged and operating properties and in some cases in the development phase. Once a core has been established, diversification into predevelopment stage and leveraged properties in growing areas may be desirable to increase returns.

IV. Implementing a Real Estate Investment Program:

A. Recommends using an outside advisor unless you have the ability to higher within.

B. A different selection process is needed than is used for securities. To look at prospective managers make sure you do an extensive analysis on the group of people that may be working with the fund, the other things they may be investing in (conflict of interest), and the properties they are already involved with.

C. Once selected, work together on a plan of investment and a budget for the first year. Determine the amount of discretion, beforehand that the investor will have.

D. Establish quarterly reporting procedures and annual meetings to keep track of what the portfolio is doing.

E. Recommends a weighted average based on the performance of open-ended funds as a standard measure until the industry comes up with a measure of performance.

Overall the article was pretty useful, looking at investment from the institutions standpoint. As pension funds are growing in popularity, the information, though fairly simplistic, is relevant.

THE TAX REFORM ACT OF 1984: Its Impact on Real Estate Transactions
by

Kenneth Leventhal & Co.

Although these readings get very technical, the outline will, hopefully, grasp the general ideas.

Sales & Exchanges

1. **Delayed** like-kind exchanges can qualify for like-kind exchange treatment even if the identity of the second property was not known at the time of transfer of the first property. However, the second property must transfer within 180 days or by the taxpayer's tax return due date, whichever is earlier.
2. **General Partnership Interests** do not qualify as exchanges.

Capital Gains and Losses

1. **Depreciation Recapture on Installment Sales:** the seller will immediately recognize all recapture income (ACRS - S/L). The recapture income is first added to the property basis, then, installment sale percentages are calculated. Recapture is at ordinary income tax rate.
2. **Change in Long-Term Holding Period:** before=1 year, now=6 months.

Depreciation and Investment Tax Credit

1. **Extension of ACRS Life to 18 years.** AS under prior law, 175% declining-balance and switching to S/L may be used. Also can depreciate over 18, 35 or 45 years.
2. **Low-income housing** can still be depreciated over a 15-year period, 200% db, switching to straight-line.
3. **Property held for sale in the ordinary course of business** (such as **dealers** selling condos) is not depreciable.
4. In calculating cost recovery deduction, assume **midmonth** acquisition or disposition.
5. **Carryover transactions** include: sale-leasebacks, acquisitions from "related person" and tax-free acquisitions from corporate or p/ship contributions or distributions. Ex: If x buys property from y for \$1,900,000 and y's s/l depreciable basis is down to \$1 million, x can continue depreciating that \$1 million down at s/l (carry it over) and depreciate the \$900,000 at 18 year ACRS.
6. **Demolition costs** must be added to cost basis of the land. I don't think it's deductible.
7. **Rehab** expenditures on low-income rental housing can be amortized s/l over 60 months.
- 8.* **ITC qualifications:** a) at least 50% of external walls and; b) at least 75% of internal structural framework have to be retained in place.
9. Can deduct up to \$25,000 for removing handicapped barriers. Otherwise, capitalized.

DEPRECIATION AND ITC ON PERSONAL PROPERTY

The following applies to cars and other transport, computer equipment, property used for entertainment, and any other designated by IRS in regs. Generally, taxpayer can depreciate and use ITC on property used for business. But, if also used for personal purposes, limitations are imposed:

1. To qualify for ITC and ACRS, personal property must be used for business more than 50% of the time, not including investment use
2. Employee cannot deduct or credit unless he/she can show significant reason for purchasing or leasing property. Employer's statement is not sufficient. Commuting to and from work remains "personal" even if taxpayer dictates memos or makes business telephone calls.
3. If #1 does not apply, use **extended period schedule**. Percentage of the annual depreciation to be taken is the sum of percentage used for business and percentage used for investment activities.
4. Above applies to persons leasing from a leasing business but does not apply to the leasing business.
5. Must keep proper records; if not, subject to penalties.

LEASING ACTIVITIES

1. Act denies ITC to taxable entity leasing to governments and other tax-exempt organizations.
2. If leasing personal property to tax-exempt organizations, normal cost recovery is not allowed—owner limited to s/l depreciation (for exceptions to restrictions, read article)
3. If real property is — 1)tax-exempt bond financed; 2)fixed price purchase option; 3)lease term>20 years; or 4)use occurs after a sale, lease or other transfer of the property by exempt lessee —and >35% of property is leased to a tax-exempt organization, then benefits are restricted. Owner has to depreciate s/l over 40 years or 125% of lease term, whichever is greater. As long as some of the interests in partnership is leased or owned by tax-exempt organization, limitations apply and p/ship's property will be considered tax-exempt use. Exception: when all allocations in p/ship are proportional.
4. Tax-exempt includes private organizations, ie, pension funds, educational and charitable institutions...However, considered nontax-exempt usage if use of property subject to the unrelated business income tax.
5. Lessor can pass ITC to lessee if lessor is "at-risk". Lessor need not be at risk if: 1)lessor mfrd property; 2) property has ascertainable fmV; or 3)IRS determines exception is appropriate. Lessee's use of ITC allowed if following test met: [PV of noncontingent lease payments using statutory IR on tax deficiencies / value of property] must be at least [2x ITC percentage + 10%] or [60% for 3 year ACRS]. Reason for limitation: lessee makes lease payments but does not acquire basis in assets.

850

Overview: The article looks at the economic conditions and trends for the 1980s. She reviews the overall economy including an analysis of the recovery from the recession, as well as, the changes in the supply and cost of funds to finance investment and cost of construction. Finally, a reference to the shift toward service and hi-tech industry is examined. The article does not really bring up any truly enlightening points. Pretty basic.

I. Overview of the Past Economy

A. The recession of '82

1. Residential fixed financing is decreasing but late '82 increases.
2. Real business investment down as well as the utilization rate.
3. ~~Personal consumption is up due to inc. employment and consumer confidence.~~
4. Only real bright spot is the decr. in inflation. This is important to the recovery that began in the end of '82 as it boosted the purchasing power and real gains of the GNP.

B. Recovery from the Recession: by '83 well underway

1. Increase in housing starts and consumer spending
2. Inc. in fixed asset business investments

C. Forecast for the rest of '83

1. inflation should be modest from 4-5%
2. speculative view of the interest rate. Predicts that they should begin to edge up (which they did) in June. Blames this on the heavy demand for consumer, and business credit, as well as the large debt service for the deficit so gov't also demands credit.

II. Changes in the supply and Cost of funds: primarily due to the higher int. rate.

A. Decr. in mortgage funds since 1980

B. Decr. in personal savings rate.

III. Shift of employment to Service and High Tech

A. Recent transformation results in incr. development opportunity

1. Inc. white collar workers=inc. in demand for office
2. Change in the character of development with greater space/worker
3. Article does not forecast inc. demand as a peak was reached in 1970 with over production. suggests a change in use.
4. Points out the move to hi tech is labor rather than capital intensive resulting in a completely different use of space.
5. Finally, the author projects the Midwest as a growth area due to the favorable climate (to hi tech with a well educated labor force and the proximity of the university system.

Inflation and the
Real Estate Investor
Author: Paul Wendt, Jan 30th

I. Real Estate is commonly regarded as a superhedge against inflation.

but

II. "The effects of inflation on real estate investment and investors are more complex and varied than commonly is presumed." Inflation is both good and bad for real estate. Positive effects on property income are offset by its negative influences on real estate financing. Impact of inflation also differs according to different property types, existing properties vs. new development etc.

III. Effects of Inflation on Existing Properties:

Rental income and operating exp. both increase. Because operating expenses are only a fraction of gross income, the same % increase in both will result in a greater NOI for the investor. This generally good. But there might be a short term problem if rent increases lag hikes in op. expenses.

IV. Effects of Inflation on New Properties: Different from effects on existing properties. Developer often faced with simultaneously rising interest expense on his construction loan and also rising construction costs.

Also, rising interest rates cause investor target rates of return to increase as well as cap rates. Capitalized value of project will be lower.

This thinking is highly relevant since often a development project has a time line of 3 years or more.

V. Effects of Inflation on Unimproved Land: Unimproved land values are subject to adverse short run and positive long run influences during inflationary periods. Short term: Increases in construction costs and interest rates are reflected quickly in lower residual returns to land.

General:

VI. Further consideration of the impact of inflation on individual properties and investors leads to the conclusion that its effect varies among new and old properties, and among different property types. Shopping centers and other commercial, or industrial, properties with escalation clauses in their leases often provide excellent inflation hedges. Long term leased fee properties with no escalation clauses would be affected adversely. Investors in residential properties subject to rent controls are the most adversely affected by inflation, as their taxes, maintenance, and other operating costs rise while rent increases usually lag behind. These observations emphasize the diverse impact of inflation on different investor and property types."

VII. The Role of Expectations: The significant role of expectations in money and capital markets emphasizes the importance of timing in real estate investment decisions. If, for example, present house prices and interest rates already reflect inflationary expectations by lenders and investors, any failure in their realization could result in capital losses rather than gains. It would seem to follow that successful investor experience in real estate, as in the stock market, would require anticipation of future inflation by the investor before it is fully discounted in the marketplace.

VIII. Rest of article goes through and discusses studies of investment returns on various types of real estate - SFH, multifamily apts., shopping centers - by various people. They all conclude that real estate is a good inflation hedge.

The Future of the Real Estate
Industry: New Directions and New Roles.
Jan 23rd. *Author M. Mahan*

I. Article was written in 1977.

II. Article's thesis is that the 1973-75 recession when the industry was way overbuilt was a turning point. The author thinks that a new real estate industry will emerge that will be different from the one of the last 20 years. Article explores the nature of the restructuring.

III. The author begins with some long term trends he sees occurring.

1. Demand for r.e. will vary considerably in the future. Housing demand will be strong. Retail, office, industrial will be weaker than in the past 30 years.
2. Geographic demand patterns will be diverse.
3. Cost of land will escalate as a result of increasing govt. regulation.
4. Costs of labor and materials will not rise as fast as in the past because of improved production systems and lessening influence of construction trade unions.
5. Continued shift in real estate capital from debt to equity because financial institutions will try to hedge against inflation.

IV. Characteristics of Tommorrow's R.E. industry.

A. Real Estate will not be a growth industry: Real Estate grew tremendously from WWII to present because of economic boom and war. Very little building took place during the depression or war. Then exploding economy.

Outlook for future is one of slow growth. Aggregate demand for land use other than housing is not increasing as rapidly as in the past. Principal source of demand for non-housing structures is from shifts of population from one region to another.

B. Real Estate will be more highly regulated: The socialization of America's real estate industry is moving full steam ahead. Increasingly stringent land use controls at the local level. Traditional property rights are being replaced by "development rights" that are defined and allocated by govt. policy. Under such a policy only those who are able to secure rationed govt. approvals are allowed to proceed with projects. SEC and state regulation of syndication. Consumer protection, environmental protection regs, rent control etc.

C. The ownership of real estate is reconcentrating: The ownership of real estate in the United States has historically moved in long-term cycles between "stronger" (institutional and wealthy investors) to "weaker" (small investor) hands. These cycles are correlated with business cycles and the investment policies of major financial institutions. i.e. when times get tough institutions foreclose on alot of properties. The author sees this occuring.

D. The real estate industry will be less profitable: Inevitable result of lower demand patterns, greater govt. regulation, and greater concentration of ownership (in the hands of institutions).

V. Future Roles in the Real Estate Industry.

1. Fundamental changes in the roles played by major participants. Some roles will disappear and others will emerge to meet new needs.

A. Financial Institutions: will dominate the real estate industry of the future. As they become owners rather than lien holders they will influence the type of development, where it occurs, and when it takes place.

Points: Longer development periods require greater financial resources.

Institutions can more readily assure govt. of quality.

Institutions are already heavily regulated and can adapt more easily to govt. regulation.

B. Developers: Role will probably go through great change in the coming decade. "The real estate developer of the future will have much less flexibility to operate. Govt. will dictate alot of the type and form of development, financial institutions will own alot of new development, and the developer will increasingly become an implementer of the desires of others.

C. Landowners: Land speculation has traditionally been one of the major profit centers in real estate. Govt. regulation and lengthy development process have taken profits out of land speculation. Speculators will, in the future, deal with less land and concentrate on areas where there is a strong chance of getting govt. approvals such as infill development.

D. Other Players: Author makes a few projections as to future of architectural services (less needed since there will be fewer new developments), brokers and mortgage bankers (fewer needed since institutions will develop directly), and property management (more important since costs are rising).

D. New Roles in the Real Estate Industry:

1. Investor-developer: Guy who options land, prepares a plan, secures the necessary govt. approvals, then sells it for development purposes.

2. Firms that find properties (investment properties) for institutional invest.

3. "specializing in prop management of scattered national portfolios,

Peter Jobson

How State Death Taxes
Affect Overall Estate Planning
Feb. 27th C

I. This article is missing every other page. I don't know if Graaskamp just wants us to read certain parts or what. I'll summarize what seems to be relevant, since I'm not sure exactly what he wants us to look at.

II. "Chapter provides material necessary for a preliminary survey of state death tax liability"

III. A number of factors will affect how much and what is taxed. These things are 1) How close a relative the inheritor is -- the closest relatives such as kids and spouse are taxed the least. 2) The location of the property makes a difference -- a deceased person's house can actually be taxed by more than one state. If that person owns a second home in, say Minnesota, but is a resident of Wisconsin, both states can tax the property.

The article recommends seeing tax counsel to plan for minimization of taxes.

IV. The next page of the article deals with different kinds of property taxed.

Real property: State is not supposed to tax property located outside its boundaries. Liable for tax in the state in which decedent's property is situated. Seems to contradict the above.

Tangible Personal Property: Taxable only in the state in which it has a taxable "situs".

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Chapter 9: Text Selecting the Ownership Entity

I. The ownership vehicles that can be used to acquire and own real estate can be classified as follows:

A. Non corporate forms of ownership -- individual, joint tenancy tenancy in common, general partnership, ltd. partnership, family partnership, and joint venture.

B. Corporations and Trusts -- Regular(subchapter c) corporation, Subchapter S corporation, REIT, pension trust, and other types of trusts.

C. Syndication -- Although syndication is not a legal form of entity , it is commonly classified as a form of ownership as well as a method of financing and marketing real estate investments.

Purpose of the chapter is to examine the various types of entities available and develop a general framework for evaluating the alternatives.

II. Ownership Decision Model: Authors have created a flowchart kind of decision model. First stage is to set investment objectives within context of risk and return. Then, here's where we come in, the investor develops selection criteria to help select the ownership entity; there are 15 of these in the model. Third, ownership alternatives are defined. Finally, ownership alternatives are ranked and one selected.

Sound like alot of academic bullshit? Well, you've got to remember that these guys make a buck by writing these text books. I'd say that this is about a six beer rating, which means that each guy had to have slammed a six pack before they came up with this model.

A. Step 2: Ownership selection criteria: 15 of these. Basically entails picking out what characteristics of the possible ownership entities are most important to you.

1. Tax Considerations: Critical. Basic choice is between a form of ownership that offers the advantage of a single tax on income and a corporate form of ownership, which is double taxed. In addition to double taxation, other tax aspects to consider are:

1a. Ability to pass through tax losses.

1b. Max income tax deductions. Some forms better suited to a more aggressive tax shelter structure -- can take liberal tax deductions without being questioned. e.g. A corporation can deduct medical and dental expenses for corporate officers without problem, but a partnership cannot do the same for partners.

1c. Favorable Cap. Gains Treatment: Easier to achieve with some forms than others.

1d. Flexibility in allocating gains and losses: choose to allocate different items of taxable income and losses so it is consistent with individual needs for tax shelter, capital gain, and cash flow. Special allocations possible with some entity forms but not with others.

1e. Estate Tax Treatment: What forms are liquid, which are not.

Of course, tax treatment and planning is not the only factor affecting the choice of ownership form. Below are the other 14 selection criteria listed in the book.

2. Limited Liability: self explanatory

3. Marketability and Transferability of Interest: With some forms of ownership, transferring an interest in R.E. or the R.E. itself if timely disposition with a minimum of legal hassle and expense is desired.

4. Flexibility and Allowed Real Estate Activities: REITs and Pension fund trusts for example are very limited in what they can do. In contrast, individual owners have almost complete flexibility

5. Management Control and Expertise: The number of people required to run an enterprise, the type of management and expertise needed, and the degree of control exercised by the investor all vary for different forms of ownership. e.g. REIT may require a substantial number of experienced people to operate, and the investor has no control. Professionally managed. Gen Partnership may consist of a few people having a high degree of control over property.

6. Continuity: Some ventures organized with a ltd. holding period in mind and would cease to exist if certain key people died. Other ventures can span the lifetimes of many projects and investors

7. Degree of Privacy: Use of certain types of trust devices and partnership agreements can easily accommodate such objectives. Names appear in public records, partnership agreements, deeds etc.

8. Favorable Public Image: Corporations inspire public confidence. REITs and ltd. partnerships sometimes looked upon as sleazy.

9. Govt. Controls and Reporting Requirements: REITs, ltd. partnerships and corporations are regulated to some degree. Individual ownership or joint tenancy not regulated. Reporting requirements also vary.

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15. Other:

III. The Authors suggest assigning relative weights to the selection criteria to determine the one best suited.

IV. Article next discusses seven noncorporate forms of ownership. They have in common that they are all single tax conduits and generally all lack continuity of life.

A. Individual Ownership:

Advantages: ind. tax rate may be lower than corp. tax rate, pass through on tax losses, complete control, might be easier to liquidate than partial interest, most confidential form available.

Disadvantages: unlimited liability, recommended mostly for small scale operations.

B. Joint Tenancy: JT exists when several people own the entire real estate. Each investor has the same ownership interest in a single parcel of R.E. Each owns an individual interest in the entire property, and the survivor takes the entire property. Treated differently in different states. Liable for all expenses incurred on a property.

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Tenant in common entitled to sue for partition if there is disagreement. If no settlement, property will be sold and proceeds divided.

Property may not be sold, leased, or mortgaged without consent of all the investors. Only viable for small investment groups.

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E. Family Partnerships: Can be established to lower overall tax burden. Divide the gains from property among low or no income members of the family. Parent makes a gift to kids, pays any applicable gift taxes, and shifts gains from property to kids' lower tax bracket. Kids become partners. IRS scrutinizes these arrangements very closely to make sure its not just a tax scam.

Subchapter S: All advantages of a regular corp. But not practicable for real estate. Requirement that no more than 20% of income can be derived from passive sources. This ~~xxxx~~ includes rents. Might be used for hotel/motel (classified as active sources), R.E. brokerage and development, subdividing land.

Other disadvantages: limitation on # of shareholders and type of stock (only 1 type allowed) limits transferability. Also, tax losses can only be deducted to the extent of the shareholders' basis in shares.

Reit: Set up by Congress to : allow small scale investors to participate in large scale real estate. And to help finance large projects. There are mortgage reits, equity reit and hybrid reits. Managed by trustees.

Reits sometimes referred to as the mutual fund of real estate Organized to earn immediate income and distribute that income to investors. Shares easily transferrable, single tax conduit, ltd. liability for investors, continuity. Reit has many advantages but to retain them it must meet stringent standards of IRS on page 235. (list)

Disadvantages of Reits:

1. Strict rules and regs. i.e. gov't. red tape.
2. Probability of losing Reit status: If it doesn't comply with strict rules and regs.
3. Limited tax shelters: Reit can shelter cash flow and distribute tax free cash, but it can't pass through tax losses to ~~xxxxxxx~~ investors.
4. Limited ~~xxx~~ growth potential: must pass 90% of income through. Not a good estate builder.
5. Tough to use for a single property because of substantial costs to organize and long time period involved.

Reit best suited to large institutional type of investing. A lot of red tape involved. Fiduciary status etc. Not for entrepreneur who has to move fast.

Other types of trusts:

1. Revocable/Irrevocable trusts: different characteristics as to taxability, privacy, flexibility, estate taxation etc. Basic distinction is that grantor can revoke a revocable trust but not an irrevocable trust.
2. Clifford trust: established for 10 yrs. ~~or~~ or the life of the beneficiary, whichever is less. Afterward the property interests revert to the grantor.
3. Offshore trust: Tax haven strategies. Set up in countries with favorable tax treaties with U.S. Income subject to very low rate and capital gains exempt. To qualify the foreign investor can't be "actively engaged in ~~an~~ a U.S. trade or business" and can't be in U.S. for more than 183 days of year. I think they shut ~~xx~~ this down in 1984 though. Repealed the effect of the old international tax treaties.

How State Death Taxes
Affect Overall Estate Planning
Feb. 27th C

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Chapter 27 - The Real Estate Investment Outlook

This entire chapter is of dubious value b/c it was written just as Reagan was elected.

- I. Inflation: If the budget is brought under control, inflation will decline to 7-10%; if not, inflation will continue to the 10-13% range. (See what I mean?)
- II. The overall forecast: Prospects are good; developers are more experienced, better capitalized and more pragmatic. Financing will be more complicated at securities markets and pension funds will be more active.
- III. Market outlook for different types of real estate:
 - A. Generally: Population moves from North to South will not be important as need to move from suburbs back to cities. U.S. needs to encourage shift from blue collar work service and white collar employment. See graph for regional pop. changes. Social and economic changes as real estate will be:
 - 1) shorter work-week and more home-related leisure
 - 2) female employment will increase along w/white collar jobs
 - 3) cities will be safer
 - 4) factory layout and size will be more efficient and service sector will increase greatly.
 - B. Industrial building and parks: National and international facilities will continue to benefit SouthWest especially for white collar jobs.
 - C. Housing: Condo demand will be up due to demand by first-buyers and empty nesters. High financing costs and rent control will cause big shortages of rental housing. Home ownership still preferred choice, but higher costs will force greater percentage of income to housing and more purchases of town-houses and patio homes.
 - D. Office Buildings: Office space demand will increase due to more white collar and service jobs. Northern city rental costs being double that of southern cities will more shifts to the South of corporate headquarters. There will be more user ownership and construction of larger and multi-use complexes.
 - E. Shopping Centers: National center developers will move downward to second and third strata metro. areas. Energy costs and building restrictions will cause more renovation of older, well-located centers.
 - F. Hotels and motels: Remains *risky*. Hotels that cater to traveling public as well as downtown luxury hotels will decline. Hotels on CBDs that cater to convention and business trade have growth potential.

IV. What financing will be available

A. Equity financing: Equity financing will be readily available, especially from syndications, pension funds, REITs, and mortgage pools, but this based on assumption of high inflation. These entities will make it easier for passive investment.

B. Debt Capital: Assumption of high inflation will lead to restricted permanent capital, conservative leverage strategies and creative financing.

C. Changes in ^{between} financial institutions: Will be blurring of distinctions, ~~blur~~ institutions as major retailers (Sears) and manufacturers (GE) get into real estate lending.

D. Secondary markets: Secondary mortgage markets will be one of the most substantial sources of housing money.

V. Costs of urban containment: According to the author, the conversion of prime agricultural land into middle class subdivision is like wrapping fish with the Dead Sea Scrolls. Author sees an increasing pressure for control in real estate developers. Even though more development restrictions will reduce the supply of income properties, higher mortgage constants and operating costs will slow the growth of real estate values unless rents rise substantially.

VI. Author concludes with comments about future real estate decision-making through academic modeling techniques. Real estate markets are as yet too qualitative to make such models predictive.

Focus of article is to gain insights into the economics of real estate investment management.

The fund level investment management life cycle is comprised of strategy formulation (establishing investment policy), implementation (selecting managers and initiating the property investment life cycle), and monitoring (reviewing performance and modifying strategy). The property level investment management life cycle is comprised of origination (investment acquisition), operations (portfolio management) and completion (investment disposition). Focus here is on investment management at the property level.

Acquisition: This aspect is critical to the overall investment management process, but a survey 100 portfolio managers revealed that evaluation of an investment prospect is inadequate and unaudited. Survey found that 100 person days are spent on property acquisition, even though the managers had little confidence in the information available about real estate investments as compared to securities. Conclusion here that a lot more is spent to acquire real estate than comparably priced securities.

Management and Compensation: There are 3 types of compensation arrangements for institutional real estate managers:

- 1) Custodial management system is based on annual fixed fee, calculated as a percentage of invested capital and is used by financial institutions.
- 2) Front end intensive fee system more lucrative and pays like brokerage for acquisition, like property management for operations, and on cost basis for property disposition. This is typical among publicly sponsored real estate securities programs.
- 3) Modern investment management system provides sufficient compensation to cover the costs of acquisition analysis plus a substantial incentive for superior performance. Author says this system entails a closer merging of goals between investor and manager.

Author explains that compensation arrangements provide either substantial compensation during acquisition (like brokerage) - before performance has been achieved, or inadequate compensation to permit sufficient analysis. This will discourage front end research and encourage the acquisition of a large risk-minimizing portfolio which does not exploit the *gains* that might be available through better acquisition techniques.

New Way of Compensation: According to the author, ~~what~~ he has shown is that the compensation during the three stages of real estate investment ~~xxxxxx~~ does not match the cost of those stages, leading to distortions

and less than optimal performance (e.g. the undercompensation for acquisition in the combined fund encourages ~~higher~~ higher asset base where the compensation is). Thus the author encourages a somewhat unspecified 'goal congruent' investment management structure which covers the relative costs of each phase, plus appropriate incentives where most needed (e.g. acquisitions).

Abstract of Wednesday, Feb. 5 Reading, D

Institutional Strategies for Real Estate Equity Investment,
John McMahan

prepared by: Mark J. Olson

author: McMahan

Overview: Pension funds are ~~finally~~^{investing} more of their portfolio into real estate. Inflation is the major impetus. They want to diversify in order to spread investment risk, with the assumption that RE equities will not erode portfolio values, and spurred by the fact that inflationary pressures will continue into the foreseeable future. RE investmmt vehicles are explored in this reading, discussions on developing a portfolio, and the factors involved.

- There are many different forms of investment participation. Vehicles include ownership, stock in RE firms, REITs, inv. trusts, and pension fund open and/or closed-end funds.
- RE has demonstrated comparable, and, in the case of higher inflation, superior performance to bonds and equity securities. Volatility is lower, systematic risk varies inversely with securities, and also acts as an inflation hedge. RE, however, is illiquid.
- Advantages of common stock of RE firms are liquidity, immediate diversification, and a daily quoted value. Disadvantages are that these are highly cyclical industries, and the securities market doesn't recognize the underlying RE assets.
- REITs also offer immediate diversification and liquidity. However, they have a questionable reputation because of the excesses of the '72-'75 recession.
- Syndications offer some aspects of liquidity, but less so than stock. From a pension fund viewpoint, they have been targeted toward smaller, tax-oriented investors and seem riskier.
- Open -end funds allow investors to purchase units in a trust which owns real estate, and have been specifically designed for pension funds. Again, these offer diversity and liquidity. Mgrs. of these funds don't have to "get the money out." The going in and going out prices are based upon appraised values.
- Closed-end funds are smaller and more regionally focused, generally. Participants are required to wait until fund is dissolved to realize returns. This is the most illiquid of the types, but returns could be quite high.
- Separate mged accts are custom-designed portfolios to reach specific objectives of the pension fund. Could be higher quality, but mgmt time is intense.

- A reasonable range of percentage of portfolio in RE is 10 to 30%, with initial inv. at the lower end of the scale.
- Diversification in geography should consider natural disaster, deterioration in the economy, or an adverse regulatory environment.
- Diversification in product should consider diversity in type of RE asset, and a good mix of tenants with staggered terms.
- Size of portfolio reaches a critical mass of diversification when it reaches six properties.
- Larger funds should consider separately mged accts, whereas smaller funds should consider pooled investing unless they expect assets to reach \$80M in the near future.
- Most pension fund mgrs invest on a free-and-clear (unleveraged) basis.
- Most institutional investments are made when the property is operat
- Disposition of property should consider timing of selling high.

Monday Feb. 10, 1986 A.

Chapter 13, REAL ESTATE INVESTMENT-PYHRR & COOPER: TAX PLANNING AND FINANCIAL ANALYSIS

by RALPH CRAM

OVERVIEW This chapter waterskis over the topic of tax planning that is covered in our other book, Tax Planning for Real Estate Investors, so I will only summarize the major issues of the chapter. I suggest that you look over chief's 550 lecture notes on tax strategy for the exam. I estimate that it will take me three beers to outline this article. Lets see how well I can do at estimating my capacity.

(Beer no# 1)

The most important issues in tax planning is NOT to invest in real estate just for tax shelter and to structure the tax aspect of the deal before the property is build or bought. Tax benefits turn a good economic investment into a superior financial vehicle if planned correctly. Never, ever spend a hard dollar to get only 50 cents of tax shelter. (Off soapbox.)

Taxes is the game of hide the pickle from Uncle Sam for as long as you can. Since most of you have done a 1040 form or will be doing one shortly, I will skip the definitions of income, and other elementary terms from 550.

Capital Gains are realized on the sale of property or assets not held for primary sale. There is four type of capital gains: short-term gains or losses and long-term gains or losses. Only long term capital gains receive preferential tax treatment. The definition of a long term asset or qualifying sale of property is:

1. a capital asset or Section 1231 property
2. owned for a period greater than 12 months
3. not owned by an investor who is a dealer of real estate unless under special conditions
4. Straight line depreciation is used.

If one is a dealer of real estate, one must aggressively position oneself as a passive investor in long-term hold position to protect the investment's capital gains status from an IRS reclassification as income. On this note, it has been said that the best investment you can make after earning \$35,000 a year is a good tax accountant.

Under the 1981 tax act, all depreciation using the ACRM method and only the excessive depreciation, if the property is low income housing, is recaptured at ordinary income. Capital gains tax is subject to only 40% of the total difference between tax basis and net selling proceeds of the property.

I will skip over elementary terms such as useful life and component depreciation. If you would like to read ancient history on pre-1981 depreciation methods, be my guest. I will mention though, that a section 179 depreciation deduction or bonus deduction in the first year of \$10,000 is available under that 1981 tax act if it has not been repealed in 1984.

MINIMUM TAXES: The add-on minimum tax and the alternative minimum tax on capital gains is to prevent the use of tax preference and long-term capital gains to reduce tax liability to near zero. Each year the investor adds together all tax preference items except capital gains and subtract \$10,000 or one half the regular income tax due and multiply it by .15 to estimate your add-on minimum tax. Alternative minimum, tax on capital gains occurs only

when it exceeds the taxpayers regular tax liability and add-on minimum tax together and if that happens, you can afford to have your accountant figure it out.

(Beer no# 2 just opened)

CREDITS: Investment tax credit of 10% and rehabilitation credit of 20% on historic buildings, as of 1986, are direct dollar for dollar reduction of tax liability. Investment tax credits, if still around next year, are applied mostly to certain components in a building that congress believes should receive such credits because their districts have industries in those sectors. Credits can be carried back and forward, and can reduce the first \$25,000 and 90% of tax liability above that amount.

INTEREST LIMITATIONS: Investment interest limitations are only on properties held just for investment and affects mostly net leased property, guaranteed returns in partnerships, and undeveloped land in the real estate area; refer to your tax professional or the other book for current information.

TAX PLANNING ALTERNATIVES AND ISSUES:

TIMING OF INCOME is very important in tax planning as one can use the nature of the enterprise's cash flows to reduce the tax liability of the firm or delay the tax outflow for a few more months to earn interest on it.

CASH ACCOUNTING has been severely restricted by the 1984 tax act; refer to Tax Planning For Real Estate Investors for further details.

OPERATING DEDUCTIONS should be expensed when every possible unless the IRS says to capitalized it. By keep the property in top repair through regular maintenance, income can be converted into capital gains recaptured upon sale.

DEBATABLE DEDUCTIONS are lease-purchase contracts, which the IRS consider to have partial principle payment within it, security deposits, which are comingled with regular bank accounts, and price in excess of market value, which the amount above market value is disallowed for tax purposes.

(Beer no# 2 just finished)

IRS AUDIT: If one receives a deficiency judgement one can pay it with interest, Appeal to Appellate Conference or Tax Court, sue the IRS in Federal District Court or Court of Claims. Ultimately one can take it to the U.S. Supreme Court. Remember that fighting the IRS is expensive and if you lose, you must pay the back taxes, interest plus court costs! Sometimes being right is not worth it.

TAX SHELTER STRATEGY

(Beer No# 3 opened)

The game plan is to create cash flow and the highest possible taxable income losses, not real economic losses, to offset income from other areas. The stages of tax shelter are:

Excess tax shelter: losses shelter other income sources

Complete tax shelter: shelters property's income only

Partial tax shelter : shelters part of property income.

No tax shelter: self explanatory

Negative tax shelter: more tax liability than income from property.

TAX SHELTER PITFALLS

--Depreciation write-offs create future taxable gains.

--Some tax Depreciation is real economic depreciation.

--Greater leverage creates financial risks.

--Tax law reforms often reduce shelter benefits.

TAX SHELTER CHECKLIST

Acquisition period objective is to create the maximum amount of tax deductions and credit in the first year.

Operation period variables are:

- Depreciation deductions
- Interest deduction and leverage
- Operating expenses and revenue
- Investment tax credits
- Margin tax rate of investor.

Termination period variables are:

- Price and terms of sale
- Installment sales treatment
- Income averaging
- Tax free exchange
- Allocation of sales price between components
- Gift or Trust

This has been a summary of a survey chapter, most of the these topics will be covered in more detail in Tax Planning for Real Estate Investors. Beer no# 3 just finished, which proves my theory that ability to estimate capacity is an important real estate skill.

THE NEW MARITAL DEDUCTION QUALIFIED TERMINABLE INTEREST TRUST (QTIP):
PLANNING AND DRAFTING CONSIDERATIONS

AUTHOR: MALCOM A. MOORE

PREPARED BY: JOE GOMEZ

DATE ASSIGNED: FEBRUARY 26, 1986 (B)

SYNOPSIS: THIS ARTICLE OUTLINES THE STEPS ONE SHOULD CONSIDER WHEN PREPARING A QTIP TRUST. RECALL THAT QTIP TRUSTS WERE BROUGHT ON BY THE ECONOMIC RECOVERY TAX ACT OF 1981 (ERTA). THE SIGNIFICANCE OF THE QTIP TRUST IS THAT THE SURVIVING SPOUSE DOES NOT HAVE TO BE GIVEN CONTROL OVER ULTIMATE DISPOSITION OF THE PROPERTY PUT IN TRUST IN ORDER TO OBTAIN THE BENEFIT OF CLAIMING THE DECEDENT AS AN UNLIMITED MARITAL DEDUCTION.

(I) REQUIREMENTS FOR TERMINABLE INTEREST PROPERTY:

- 1) PROPERTY MUST PASS FROM DECEDENT(DONOR) SPOUSE TO DONEE SPOUSE.
- 2) SURVIVING SPOUSE MUST BE ENTITLED TO ALL INCOME FROM THE TRANSFERRED PROPERTY AT LEAST ANNUALLY.
- 3) NO ONE CAN HAVE THE POWER TO APPOINT ANY PART OF THE PROPERTY DURING THE SPOUSES LIFE TO ANY ONE BUT THE SPOUSE.
- 4) ELECTION MUST BE MADE BY DECEASED DONORS EXECUTOR ON THE FED TAX RETURN, CLAIMING THE DEDUCTION IN WHOLE OR PART.

(II) INCOME PAYMENT REQUIREMENT:

THE QTIP PROPERTY NEED NOT BE INCOME PRODUCING, BUT THE SURVIVING SPOUSE MUST BE GIVEN THE RIGHT TO MAKE IT INCOME PRODUCING IF HE/SHE SO CHOOSES. FOR EXAMPLE IF A PERSONAL RESIDENCE IS HELD AS QTIP PROPERTY THE SURVIVING SPOUSE CAN ELECT TO SELL THE RESIDENCE AND INVEST THE PROCEEDS IN INCOME PRODUCING PROPERTY TO BE HELD IN THE QTIP TRUST. IT IS ALSO IMPORTANT TO REMEMBER THAT, UPON THE DEATH OF THE SURVIVING SPOUSE, ALL ACCRUED BUT UNPAID INCOME GENERATED BY THE TRUST SHOULD BE DIRECTED TO THE ESTATE. IN THE EVENT THAT IT IS NOT, THE MARITAL DEDUCTION WILL BE LOST.

(III) PROHIBITION AGAINST POWER OF APPOINTMENT:

ONLY THE SPOUSE MAY BE A TRUST BENEFICIARY DURING THE SPOUSES LIFE. ALSO, THE SPOUSE CAN ONLY WITHDRAW UP TO 5% OF THE TRUSTS PROPERTY FROM THE TRUST, AND NO DIRECT GIFTS, FROM TRUST PROPERTY, CAN BE MADE TO THE CHILDREN

(IV) ELECTION FOR QUALIFICATION:

QUALIFICATION OF A QTIP FOR THE MARITAL DEDUCTION IS CONDITIONED UPON AN ELECTION BY THE EXECUTOR OF THE DONOR'S ESTATE.

(V) QUALIFICATION OF A "PORTION" OF PROPERTY:

AN EXECUTOR MAY ELECT TO MAKE ONLY PART OF THE PROPERTY IN THE TRUST ELIGIBLE FOR THE MARITAL DEDUCTION. ANY PROPERTY HELD IN TRUST BEYOND THE EXEMPTION EQUIVALENT IS NOT PART OF MARITAL DEDUCTION TREATMENT.

(VI) DISCLAIMER AS AN ALTERNATIVE ELECTION:

AN ALTERNATIVE TO GRANTING THE EXECUTOR THE RIGHT TO MAKE AN ELECTION AS TO WHAT PORTION OF THE PROPERTY WILL RECEIVE THE MARITAL DEDUCTION IS TO GIVE THE SURVIVING SPOUSE THE RIGHT TO DISCLAIM A CERTAIN PORTION OF THE

TRUST PROPERTY. THE PORTION THAT IS DISCLAIMED IS PLACED INTO A SEPARATE TRUST THAT IS NOT USED TO CLAIM THE MARITAL DEDUCTION. THE SEPARATE TRUST CAN BE AN IDENTICAL QTIP TRUST OR A TRUST WITH DIFFERENT PROVISIONS AND BENEFITS.

(VII) RIGHT OF RECOVERY:

THE SURVIVING SPOUSE'S ESTATE HAS THE RIGHT TO RECOVER ALL FED DEATH TAX ATTRIBUTABLE TO THE QTIP TRUST PROPERTY.

(VIII) GIFT OF QTIP PROPERTY BY SPOUSE:

IF THE SPOUSE TRANSFERS ANY PART OF THE INCOME GENERATED BY THE QTIP PROPERTY TO ANOTHER PERSON, THE RECIPIENT HAS THE RIGHT TO RECOVER ALL GIFT TAXES INCURRED FROM RECEIPT OF THE QTIP PROPERTY.

(IX) QTIP WITH CHARITABLE REMAINDER:

IF A SURVIVING OR DONEE SPOUSE RECEIVES QUALIFIED TERMINABLE INTEREST PROPERTY WITH THE REMAINDER PASSING TO CHARITY, THEN A MARITAL DEDUCTION WILL BE GRANTED FOR THE ENTIRE VALUE OF THE TRANSFER, AND UPON THE SURVIVING SPOUSE'S DEATH, OR DISPOSITION OF THE INCOME INTEREST, THE REMAINDER SHOULD QUALIFY FOR A CHARITABLE OR GIFT TAX DEDUCTION.

(X) TRANSITIONAL RULE:

IF A PRE-ERTA TRUST OR WILL CONTAINS THE WORDS "MAXIMUM MARITAL DEDUCTION" TO DESCRIBE THE MARITAL DEDUCTION SHARE, AND ALSO CONTAINS A "BY-PASS" TRUST FOR THE BENEFIT OF THE SURVIVING SPOUSE, WHICH HAPPENS TO QUALIFY AS A QTIP TRUST, THE EXECUTOR SHOULD BE ABLE TO ELECT TO HAVE THE "BY-PASS" TRUST QUALIFY AS A QTIP TRUST.

TAX PLANNING FOR REAL ESTATE INVESTORS

CHAPTER 7: ALTERNATIVE FINANCING METHODS AND TAXES

The information in the article is dated and more applicable to the last couple of years when interest rates were high.

LEVERAGE - In the past there were two basic advantages in applying leverage to an investment:

- 1- To improve the return on equity. As long as the rate of return on the entire project was greater than the A/T cost of borrowing on the mortgage.
- 2- B/T cash flow will increase at a greater rate over the holding period. This can happen when the debt service payment is fixed and the NOI increases over time.

Recent problems caused by the high cost of money:

- 1- Interest rates on mortgages are higher than the return on the entire project therefore, equity investors decrease their return by increasing the amount of debt.
- 2- Lending institutions disfavor fixed rate mortgages. Therefore they are using such methods as rollover, variable rate, participation mortgages and joint ventures to protect themselves from the cruelty of inflation.

How to analyze creative financing methods.

1- The mechanics of the technique. How does it work? What is the expected yield both before and after tax. (from the borrower- what is the cost of borrowing)

2- The tax implications. What are the tax rules related to this financing method? What are the implications for both the lender and the borrower? Are there tax implications in the event of a default? What tax problems does this method create?

3- The legal aspects of the method. What legal problems does the method create? How is the legal instrument different from the traditional? What are the typical clauses in such an instrument?

4- the decision-making implications. When would such a financing method be used? Under what investment situations would it be more advantageous than other financing methods?

The chapter then explained what a wrap-around mortgage was and if the rate on your 1st mortgage is higher than your 2nd/wrap that your 1st shouldn't be retained- pretty obvious. The chapter then explained the adjustable rate mortgage and how to determine a mortgage constant.

Participation Mortgage

In residential/ single family homes this is more commonly known as shared-appreciation mortgages. The lender would receive

the debt service plus a percentage of the increase in the property's value. In income property it can be figured by several methods. Examples are % of gross income, NOI, or the before-tax cash flow or a percentage of the income from sale. For tax purposes, the payment made under such an agreement would be treated as interest paid by the borrower/investor.

Construction Loan

Generally not made unless a "take out" agreement has been made and through a "buy/sell" agreement the construction lender is taken out by the permanent lender. Risks for the construction lender include outcomes due to cost overruns and poor construction management. To limit this the loan is generally done on draws.

Tax Aspects of Construction Loan

Interest paid on construction loans, as well as property taxes paid during construction are not deductible in the year paid. They are amortized over the following periods:

Residential Property		Non-Residential	
year paid	time period	year paid	time period
1981	7 years	1981	9 years
1982	8	1982 >	10
1983	9		
1984 >	10		

READING FOR 2/3/86, MONDAY. READING C

INFLATION AND THE REAL ESTATE INVESTOR, THE APPRASIAL JOURNAL JULY '77

PREPARED BY: JEFF RASMUSSEN

AUTHOR: PAUL WENDT

IT IS IMPORTANT TO NOTE THAT THIS ARTICLE FOCUSES ON TRENDS DURING THE DECADE FROM 1967 TO 1976.

1) The owner of existing properties with permanent financing and depreciation tax shelter is in an excellent position to profit from a general inflation.

2) For new real estate development, the effects may be in the reverse. High and rising construction and interest costs may interact with low occupancy rates & rents to produce negative cash flows, and the related risks of foreclosure.

3) This unfavorable impact of inflation on new construction, in turn has a magnified impact in the short run on the salability and prices of unimproved land ready for development. Farm and timber land are exceptions because of rising potential incomes and generally low capital requirements and interest rate effects.

4) Leasing and financing terms play a critical role in influencing the impact of inflation. Percentage and escalation-type leases, along with favorable tax clauses and renewal terms can benefit the investor. There are risks associated with rental properties subject to rent control.

5) Rising long-term interest rates dampen increases in investment values. A rise in capitalization rates and mortgage interest rates lowers equity cash flows and the capitalized value of income investments. The investor must rely on offsetting longer term influences of rising rents and increases in selling price based on higher replacement costs.

6) Shopping centers are popular investments as hedges against inflation, because the rising volume of gross sales during inflation generally contributes to increased gross incomes and residual sales prices for them. Note, this again depends on the lease terms.

7) Expectations in money and capital markets emphasize the portance of timing in real estate investment decisions. If present house prices and interest rates already reflect inflationary expectations by lenders and investors, then a failure for them to happen would result in capital losses rather than gains. In other words, the investor must anticipate future inflation before it is fully discounted in the marketplace.

8) Real estate values and investment returns can be expected to vary with the specific changes in population, incomes, interest rates, and other supply forces that may occur during any period of inflation. In the author's opinion, however, home ownership and selected other types of real estate investment have been a good hedge against inflation during the years 1967-1976.

Wednesday January 22--H

Tomarrow's Changing Demand for Real Estate

author--John McMahan
prepared by Steve Cortese

Overview: This article was written in 1976. Another sterling example of up-to-date reading. Outliner suggests not reading this article. Please keep in mind the date of publication when reading this article.

A. The Demand for Housing

1) The demand for housing is a function of population growth and household formation patterns. The major long-term factor affecting housing demand is the fact that America's population will continue to increase into the next century. Growth is largely determined by the existing level of population (the base) and the annual rate at which new people are added to the base. New people are added to the population through migration and the birth rate. This article states that the nation's population is expected to increase into the next century.

2. The rate of household formation is also increasing. This will again increase demand for housing.

3. Households will be older and smaller. this again increased demand.

However, it is possible that as a result of environment controls, skyrocketing construction costs and high interest rates, many Americans will not be able to afford new housing. Therefore, there may be a housing shortage (keep in mind the 1976 date).

B. The Demand for Retail-Commercial Facilities

The demand for shopping centers, stores, restaurants, and other retail commercial land uses is largely a function of the number of households, the level of real per capita income, and the pattern of consumer expenditure.

We Know the number of households is increasing. The question concerns economic growth and the level of inflation combined to produce and real per capita income.

The article also states that since the cost of living is going up less money will be allocated to retail purchases--reducing demand for retail space. Existing centers will then be modernized.

C. The Demand for Office Commercial Facilities

The demand for office commercial facilities is a function of the number of office employees and the way business utilize their office space.

D. The Demand for Industrial Facilities

Capital expenditures of business-firms for new plant and equipment constitute the major force behind demand for new industrial buildings. R & D expenditures and environmental requirements also play a part.

E. Regional and Local Shifts in Demand

Real Estate development, in addition to being affected by changes in aggregate demand, is also influenced by shifts in demand from one region to another or within metropolitan areas.

Terry McDaniel
22 January (E)
1850 readings

INTRAPRENEURIAL NOW
NORMAN MACRAE

Summary

An update of Norman Macrae's research on the transition of management style. From giant organizations to small profit centers, where people interact and get involved with the entire process of development and manufacturing of a new concept. A method of matching the benefits of a large organization and the small profit center's ability to generate an incremental level of work.

Brief Outline

- A. Big goes bust
 - 1. Making departments minifirms
- B. Towards inventor's intrapreneurial
 - 1. The Pinchot proposal
 - 2. A steel mill's eels
 - 3. Gadarene pearls
- C. Mature intrapreneurial
 - 1. Mr Revan's action learning
 - 2. Flour and textiles
 - 3. Instant intrapreneurial
 - 4. Buy-outs
 - 5. Ride out on the rail
 - 6. Envoi

Detail Outline

- A. Big goes bust
 - 1. The shift from industrial workers to brain workers contributes to the belief that hierarchical management cannot control how brain workers control their imagination
 - 2. View smaller firms as profit centers that become more entrepreneurial
 - 3. By 1965 smaller firms were out-performing big one... hospital example
 - 4. Communist countries have proven that the inefficient giant state farms are inefficient and going bust.
 - 5. Majority of new jobs created since 1965 come from smaller firms, while large firms tend to layoff workers, even when a majority of new smaller firms disappear in five years.
 - 6. How can we combine the entrepreneurial spirit and bigger firms?

Make departments minifirms

- 1. Two trends project in 1976:
 - a. Greater reliance on subcontracting work
 - b. Internal competition for the same business opportunity
 - 1. Size of the group critical... 10 to 12 maximum
 - 2. Pay based on productivity rather than a hourly wage
- 2. Example of the typing pool
 - a. Establish a productive criteria for the group

- b. Flexitime
- 3. R and D expenditures wasted by 300 biggest firms
 - a. Out of the 70,000 patents issued yearly nearly 60,000 come from small firms you never heard of.
 - b. 2/3 of the major inventions of the last decade came from small firms
- 4. Never underestimate the tangible and intrapreneurial excitement among a tiny group of researchers when the rewards of success are so great.

The Pinchot proposal

- 1. Gifford Pinchot outline for reforming today's corporations: "Decentralization alone is not enough. In a hierarchical organization, promotions can be won by special graces, loyalty to one's boss, and general political skills. Courage, original thought, and ability to observe the obvious do not necessarily lead to success. If we are to get really good problem-solvers in our decentralized corporations, we must introduce a system that gives the decisions to those who get successful results, not to the inoffensive....."
- 2. Pinchot suggest that intrapreneur obtain R/D funds by borrowing in-house. His rewards, if the project goes is more R/D funds, plus cash to his group.
- 3. Encourage thinking free of individual inhibitors
- 4. Schools for intrapreneurals... fuzzy idea to concept to business plan

Mature intrapreneurial

- 1. Turn of the century the two biggest employers were farming and domestic services, today they employ only four percent of the work force
- 2. Japanese have always based their continuing manufacturing miracle on tiny entrepreneurial component-makers.

Mr. Revan's action learning

- 1. On the job training is the custom rather than going to business school.
- 2. "Action learning" focuses on problem-solving small groups
- 3. Workers decide if certain aspects of the manufacturing process are terminated

Flour and textiles

- 1. Example of how a flour company closed 40 percent of its operation and increase its profits by 60 percent. It set up a "development department" and focused on its strength of marketing consumer goods. It invited proposals for small ventures based on their strength.

Instant intrapreneurial

- 1. Travel agency's pay based on low fare

Buy-outs

1. Buy-out by employee on the increase throughout the world
2. In England, banks specialize in employee buy-outs
3. Failure of a buy-out substantially less than start-up
4. Prefer small buy-out groups than large groups

The balance of the article deals with examples of intrapreneurial enterprises in England.

Jan 27, 1986
READING C.

REAL ESTATE INVESTMENT STRATEGY
prepared by: Steve Luetttgen

The purpose of this article is to give the investor knowledge of the procedures, assumption and strategy that will lead to profitable real estate investing in the 1980's. Specifically, this article is geared to properties in the \$500,000 to \$5,000,000 range.

Properties in these markets were primarily:

1. Sold with financing, 65% had downpmts of 30% or less.
2. Located in the sunbelt.
3. Purchased by individual buyers.
4. Sold by developers and existing property owners.

Three trends in this market are:

1. More downpayments in the 30 to 40% range.
2. More investment activity in the Midwest and East as investors look at alternatives in the sunbelt.
3. Fewer developer properties built for sale. More joint venture activity between developers and institutional lenders who prefer to hold the properties.

DETERMINING THE PRICE

Of the three stages of real estate investment ownership (buying, holding, selling) the acquisition stage is the most important, for if the buyer overpays, he can't operate it efficiently, nor resell at a realistic price.

Three major mistakes buyers make when determining a price:

1. Overestimating the potential income and underestimating the expense. (accounts for 60-70% of mistakes) Current income rather than future income should be used. Property taxes s/b based on the new price, reserves for replacements and leasing commissions should be included in determining the price.
2. Using existing 1st loans and sellers 2nd notes in determining the price. (20-30% of mistakes)
3. Accepting below market pretax cash flow returns. (20-30% of mistakes)

MEASURING THE YIELD

The after tax discount yield represent the most accurate measure of profit.

The investor should not lose sight of the true risk (income, expense and resale) by overemphasizing the yield, for the investor is buying the assumptions that create the yield rather than the yield itself. The yield is meaningless if the income is overstated and the expenses are unrealistic, or if the property can not be sold to the next buyer!

YIELDS ON INVESTMENT ALTERNATIVES

In order for an income property to appreciate in value, one of the following three changes must occur:

1. The net income increases over the holding period.
2. The next buyer accepts a lower pretax cash flow.
3. The lender at the date of resale decreases the interest rate.

Land investors should never acquire investment acreage without some idea of the highest and best use of the land, or who the next probable purchaser will be. By comparing the asking price today with the expected price in the future, the investor can calculate the expected A/T yield.

Investors in higher tax brackets can reduce the risk in comparison to an investor in a lower tax bracket by acquiring properties which fit his tax situation. Tax savings help determine the type of property an investor in a high tax bracket should be looking for. However, the tax savings shouldn't influence the price he pays for the property.

Profitable real estate investing involves identifying properties which have the ability to produce rental increases. Inflation alone will not increase rents. Neighborhoods change, buildings become obsolete and development cycles affect supply and demand. In order to evaluate the potential of property to produce increased net income, the buyer should have answered the following questions:

1. Is the projected scheduled gross income increasing or decreasing based on past performance?
2. How do the rents compare with other available space in the market area?
3. What is the probability of future competition?
4. Are the expenses adequate to operate the property over the projected holding period?

Properties that have a higher probability of producing increased rent have sold for a premium during the last two years. Pricing a property is a compromise between the beginning pretax cash flow return and the growth potential of the net income.

Lower pretax cash flow returns are primarily caused by a higher demand for investment properties than supply. High interest rates, fewer developers, and a smaller number of properties built for sale have reduced the supply. More activity by institutions in the \$1.5 to \$5 million price range has created a higher demand in this price classification. Institutions have been buying existing, problem free, office buildings, shopping centers and industrial parks in the sunbelt, on all cash returns which are 2 to 2 1/2 points below their most competitive long term interest rate. (1 to 1 1/2 in the midwest). Since institutional investors have bought for all cash at 2 to 2 1/2 points below their lending rate, the individual buyers in order to purchase with an institutional loan has been forced to borrow less and to accept lower pretax cash flow returns in order to compete with the institutions purchase rate.

Since profit does not become a reality until the property is sold and the resale assumption is bought by the next buyer, the purchaser, when deciding to buy and investment property, should be as concerned about what he has to offer the next buyer as with what he is buying.

Buying when the interest rates are high gives the investor the potential of selling when interest rates decline, thus creating additional value. However, when interest rates are high, lenders will attempt to obtain large prepayment penalties or lock in provisions, thus insuring the higher interest rates for a longer period of time. To take advantage of the decline in the money

market, the buyer must be in the position to remove the high interest rate loan. Thus at the time of purchase, the buyer, either by paying additional fees or a higher interest rate, should attempt to remove any loan provision which would prevent refinancing.

Since a lender contributes 60 to 70% of the money to acquire a property, as compared to buyer's 30 to 40%, fluctuations in the interest rate have a more dramatic effect on the A/T yield than changes in the pretax cash flow returns.

THERE IS A LISTING OF REAL ESTATE INVESTMENT STRATEGIES FOR THE 1980'S ON PAGES 128-129 OF THE ARTICLE. I WOULD RECOMMEND TAKING A COUPLE OF MINUTES TO LOOK AT THEM.

Evolution of Real Estate Investment Strategies and Methods

prepared by Steve Cortese

McMahan has reviewed the entire history of real estate development in the U.S. for us (in the reading packet).

A)

We can distinguish between those that were visionaries and speculators and those that were typically local investors who built, operated and owned for family purposes a growing portfolio of real estate. Most who are wealthy in real estate are those who plugged away one piece of r. e. at a time, operated it themselves and did it cumulatively. Very mundane and locally orientated. Graaskamp says most flamboyant speculators have ultimately failed and have been wiped out. Bercher (sp?) Group in California is an example of a family that pays all cash and only builds what they cash flowed the year before. Very rich even though no leveraging. Been at it a long time.

This is a essential difference in investment philosophy--those who have been in r.e. their whole lives don't see r.e. as a play. They see it as a long term role in society and community for which they are working. Other new comers see r.e. as a play and a way to skim fees. Don't see r.e. as a production enterprise but as a commodity market and money market short term play against short term phenomenon such as inflation, taxes, cost of funds, etc. They don't see larger ethical picture.

B)

This brings us to r.e. as a Straddle; call on upside if project succeeds. That is, call on commodity called space time. Typically a fungible commodity. If we can finance out on the project we have a put to the lender if the project fails. At various times some front money is required. No problem, the tax shelter enables us to regain such front money even if the project is not cash flowing. Once we regain our front money we have a classic or perfect straddle--a call on the upside, a put on the downside and it costs us nothing. This is the FIRST r.e. investment strategy.

SECOND r.e. strategy relative to equity investment has been to construct markets for services. R.e. projects are nothing more than consumers of tremendous amounts of services. Most of services are compensated for as a % of gross rather than on a basis of value added. Ex.--architect gets 5% even if only costs him 1%. Object of controlling equity is to control who gets service contracts. Tax law subsidizes strategy to control r.e. through controlling service contracts. More interested in revenues above the NI line than below the NI line. Every expenditure in the r.e. product is money for another enterprise. The object of r.e. is not to generate r.e. but to create fee income or employment for my particular level of expertise. Some say r.e. business has nothing to do with IRR but with creating a steady flow of demand for their expertise. A G.P. with no money in the property controls the profit centers. Different ploy or play than looking at r.e. as a commodity against future hope where urban environment is going.

THIRD strategy is the Robert Moses (sp?) strategy. Interested with tremendous outlays in r.e. rather than revenues. Every outlay in r.e. is a favor to another enterprise that receives it. Power is your ability to do favors. Ability to achieve stature in community is ability to control expenditures. Power base is directly proportional to ability to control expenditures. Powerful politicians and wealthy loan officers are that way because they help developers get what they need. Development machine controls development with control on jobs which in-turn controls expenditures which are basis for power. R.E. development is a means toward power. Measures of success have nothing to do with IRR or being able to compete in capital markets. R.e. is a classical institutional investment. Must understand institutional power process to understand strategy.

The only short term play in r.e is brokerage. Broker takes no responsibility for the funding or the title of the property. Skim off the top with no risk as to whether you can close the deal or not (remember ready, willing, and able buyer).

C)

The evolution of r.e. strategy has moved from being a private enterprise with private capital to a recognition that r.e. is the essence of public capital. Public can raise capital at lower nominal costs. Political risks of r.e. are created by public process and avoided by public process. So if we want to create capital for community, we may want community to take direct role in r.e. investment. This accomplishes reduced political risk--politicians will never back out once they are committed. Ultimately major r.e. investment is a matter of public entitlement. Political figures can get what they want through entitlement program. Controls power. Again a changing method of keeping score--that has nothing to do with CAPM or IRR.

D)

This brings us to the phases of r.e. thought:

1) The original capital income approach (endorsed by the American Institute and Babcock) which has three different components:

what are market rents at that particular decision point in time.
-- operating expenses
-- reserves for replacement
economic surplus

Economic surplus is the net increment to nations wealth. Deals with the long term.

Producer surplus is the portion of surplus to those who put the project together. Short term advantage in the market place.

2) The 2nd phase is Ellwood who said one had to decide if NI is great enough to pay back the loan and whether collateral value is enough to sustain borrower. The #1 security for the loan is not the property value, but that the borrower does not want to lose the property because of cash flow, equity build-up, and appreciation. So r.e. is--

r.e. = sum of PV of claims on income

This is a liability concept because:

Investment = sum of liabilities of r.e.

3) The 3rd phase are the guys who are producing the property saying:

--going to change net spendable cash as a result of ownership
or --change liquidating value of my net worth to my heirs--distributable assets

Penny in the readings does a good evolutionary analysis of the cap rate to the IRR to MIRR.

However return is meaningless if you don't account for risk.

E)

Now lets talk about the multiple layers of risk management. Today lender takes the risk not the borrower. Risk depends on how we structure the deal and points to who takes the risk. Leverage out and the bank takes the risk. No equity risk.

F)

In looking at any project relative to change in spendable cash or distributable assets we will look at these next several items in the next few weeks:

- 1) Position in market place
- 2) Time line of investment-position in time
- 3) Skills required of investor

After that the basic elements are simple:

- 1) Schedule of receipts
 - capital receipts--loan proceeds, sale of partnership units
 - operating receipts
 - public subsidies
- 2) Schedule of outlays
 - capital outlay
 - operating outlays
 - profit distributions: dividends, assessments to community
- 3) Risk/payoff matrix
 - dollar outlays--when they occur and area of occurrence
 - consequences of loss
 - capital loss
 - credibility loss (most damaging)
 - expectation loss