

California Real Estate Finance
Chapter 14
Investment Financing Strategies

Chapter Purpose

The final two chapters address the question *What are the financial strategies and math calculations for real estate finance?* Financing real estate is considered an art by some practitioners, while others pursue it as a matter of necessity. This chapter shows how financing can be applied in a sophisticated manner to achieve specific investment goals. Financing is discussed in terms of creative relationships among builders, owners, investors and financiers.

Suggestions to the Instructor

This chapter is written with the hope that it may stimulate some students to pursue further studies in real estate finance. There are many creative uses for finance not covered here, for example, Zeckendorf's Hawaiian technique where he financed the income from the improvements separately from the land and separately from the depreciation. Also, the expanding importance of securitization by private companies has opened the field to inventive persons to take new and innovative approaches to this form of finance.

Learning Objectives

Upon completion of this chapter, the student should be able to:

1. describe a sale-leaseback arrangement, including the benefits for each party involved;
2. explain the benefits and detriments to the parties involved when the sellers refinance prior to the sale;
3. design a participation agreement in the form of equity participation, sale-leaseback, split fee ownership or a joint venture;
4. demonstrate the potential profits and losses involved in pyramiding through refinancing;
5. compose and income tax deferred sale with the use of an installment contract;
6. utilize a lease with an option to buy;
7. compose an income tax deferred sale with the use of an IRS 1031 exchange.

Presentation Outline

- I. Sale-Leaseback
 - A. Technique
 1. Owner of factory or other relatively large property has exhausted depreciation
 2. Owner sells property to an investor at market value, subject to an agreeable leaseback for prescribed term
 - B. Benefits
 1. Investor has a fixed-yield investment for a specified term from an AAA tenant
 2. Seller-lessee has the cash proceeds from the sale and a substantial rental deduction as an operating expense
 3. Seller-lessee can retain control of the property by including a buy-back option to be exercised at the end of the lease term
 - a. purchase price must be at market to avoid IRS denial
 - b. right of first refusal included in the lease
 4. Doesn't apply to residential property because rent not deductible

- II. Seller Refinances Prior to the Sale
 - A. Technique
 1. Used when buyer cannot arrange new financing
 - a. suffered bankruptcy
 - b. other limited credit ability
 2. Owner secures new loan on property
 - a. proceeds to owner
 - b. proceeds not taxable at this point
 3. Owner sells to buyer
 - a. for cash down to new assumable loan
 - (1) income taxes on capital gains
 - (2) including loan proceeds
 - b. on an installment sale
 - (1) shelters capital gains
 - (2) shelters loan proceeds
 - B. Benefits and risks
 1. Buyer purchases property
 2. Owner sells property
 - a. retains contingent liability as maker of loan
 - b. in an installment arrangement, has risk inherent in low down payment transactions

- III. Trading on Seller's Equity
 - A. Technique
 1. Buyer refinances property
 2. Buyer gives loan proceeds to seller as down payment
 3. Seller carries back balance of purchase price as a junior loan

- B. Benefits and risks
 - 1. Buyer has no cash involved
 - 2. Seller has risks in event of a default

- IV. Equity Participation
 - A. Sale-Buyback
 - 1. Lender purchases completed project from developer
 - 2. Lender sells property back to developer on installment contract for deed
 - a. lender retains title
 - b. lender builds in a “kicker” into sales price to increase yields beyond interest income
 - c. developer own property without any cash
 - B. Splitting ownership
 - 1. Lender purchases land under project
 - 2. Lender leases land to developer
 - 3. Lender finances improvements on land
 - C. Joint ventures
 - 1. Partnerships
 - a. land owner
 - b. developer
 - c. lender
 - 2. With lender only
 - a. lender puts up 100% of funds
 - b. developer invests time and expertise

- V. Tax-Deferred Financing
 - A. Capital gains income
 - 1. Realized capital gains
 - a. the difference between the total consideration received and the adjusted book basis of the property transferred.
 - (1) the adjusted book basis is the amount paid for a property plus any improvements made less depreciation
 - (2) only the improvements can be depreciated, not the land
 - b. monies received from refinancing
 - c. realized gains are not taxable until they become recognized
 - 2. Recognized capital gains
 - a. the profits that are actually taxable
 - b. profits received from the sale of property
 - B. Pyramiding through refinancing
 - 1. applies to investment properties
 - 2. Purchase one property
 - a. value increases over time
 - b. rents increase over time
 - 3. Refinancing this property at its higher value
 - a. larger mortgage
 - b. higher payments

4. Use excess proceeds to purchase another property
 - a. net refinancing proceeds not taxable; are considered realized capital gain, not recognized until property sold
 - b. both properties will continue to gain value
 5. Refinance both properties
 - a. purchase two new properties
 - b. continue pyramiding until goals are met
 - c. be prepared for glitches
 - (1) properties do not increase in value over time
 - (2) poor choices of properties
 - (3) economic downturns
 - d. necessary to maintain adequate cash reserves in event of bad times
 6. Refinance when things are good
 7. Buy when things are bad
 8. Never sell, if possible
 - a. avoids capital gains taxes
 - b. constantly expanding refinance basis
 - c. property enters into books of heirs at its value at the time of death, wiping out all lifetime gains
 9. A tried and true method of establishing a substantial family estate
 - a. heirs refinance after estate is probated
 - b. have the ability to purchase larger and more efficient investment properties
 - c. continue pyramiding beyond one generation
- C. Installment sales
1. Used when buyers do not have enough cash or credit to complete a cash out sale
 - a. buyers make acceptable down payment
 - b. sellers agree to carry back a senior or junior loan for the difference to sale price
 2. Used to offset the impact of income taxes on capital gains
 - a. sellers accept a carry-back contract
 - b. only principal amounts received in year of sale or in subsequent years subject to tax as recognized income
 - (1) compute Installment Factor (gain divided by equity)
 - (2) multiply principal received in year by Installment Factor to derive annual taxable amount
 - (3) no capital gains tax impact if no principal received during year
 - (a) nothing-down, interest-only
 - (b) tax due on full amount at stop date
 - c. all interest received on contract taxable each year as ordinary income

- D. Option to buy
 - 1. Gives buyer absolute right, but not obligation, to acquire certain real estate during a specified time period
 - 2. Price and terms may be established at the outset
 - 3. Option payments not recognized as taxable income until the options is exercised or abandoned
- E. Lease with option to buy
 - 1. Property leased to tenant-buyer with options to purchase under specified terms and conditions
 - 2. Some agreements include full or partial credit toward the purchase price for rents paid
 - 3. Right of first refusal
 - a. grants the tenant-buyer an option to purchase the property, but at a price to be negotiated at the time the option is exercised
 - b. unlike the option to buy, which gives the buyer control, the right of first refusal gives the seller the right to find another buyer at a market price that may be higher than the option price
- F. Exchanges
 - 1. IRS Code Section 1031 allows exchanges of like property to postpone income tax impact
 - a. properties to be exchanged must be held for productive use in a trade or business or for investment
 - b. properties must be of like kind, i.e., real estate for real estate
 - c. properties must actually be exchanged
 - d. when exchange not equally balanced among the parties, cash or other unlike properties may be used to balance the exchange, but must be accounted for separately as “boot”
 - 2. Mathematical computations
 - a. balance the equities
 - (1) exchange price less existing loans
 - (2) make up difference with boot
 - b. determine tax impact
 - (1) derive realized gain
 - (2) derive recognized gain
 - (3) tax due on whichever is less
 - (4) upside trader usually avoids tax
 - c. reestablish new book basis
 - (1) add old basis, new mortgage, cash, boot paid and recognized gain
 - (2) subtract from this sum, the sum of the old mortgage plus the cash and boot received

VI. Distribution to Heirs

- A. All property is inheritable
 - 1. A will designates its distribution
 - 2. Real property is inherited at its value as of date of death of owner
 - 3. All past growth in value eliminated for capital gains purposes

- B. Deceased's property appraised at date of death the establish eligibility for estate tax purposes
 - 1. Federal estate tax exemption is currently \$1,000,000 net value per person, which will increase over the years
 - a. appraisal gross value
 - b. less outstanding debts
 - c. equals net value
 - 2. Includes life insurance proceeds
- C. Gift tax
 - 1. Federal law currently allows each person to make a gift to any other person of up to \$11,000 tax free each year
 - 2. Gift can be in the form of money or property
 - 3. Gifts in excess of the exemption are subject to federal and state tax