Cash Flow Analysis

- **Cash Flow Analysis for Real Estate requires using the principles of the dynamics for dollars calculations along with an understanding of Tax Implications from the operations of a Real Estate Investment**

- **Net operating Income (NOI) is the most Important number for a particular investment property!**

- **Cash Flow After Taxes (CFAT) is the most important number for a particular Investor!**

Real Estate Taxation

Real Estate Investment operations is a taxable business

Some Real Estate Investments create a tax shelter while others create a taxable event

The IRS considers income from three categories in order to calculate total taxes payable

- **A) Active Income (Wages, W-2 etc.., tips and so on**
- **B) Passive Income (Real Estate Investments…)**
- **C) Portfolio Income (stocks, bonds, dividends, capital gains)**

Passive Income rules relate to real estate and define losses allowed annually, suspended losses, cost recovery allowance etc.

Taxable Income from Operations

Net Operating Income

Less

Interest on loan payments

Less

Cost Recovery

Equals

Taxable Income/(Loss) from Operations

Cash Flow After Taxes (CFAT)

Net Operating Income

Less

Annual debt Service

Equals

Cash Flow Before Taxes

Less

Tax Liability/Savings

Equals

Cash Flow After Taxes

Real Estate Tax Terms

- Interest
- Cost Recovery
- Real Estate Taxable Income
- Cash Flow After Taxes (CFAT)
- Recapture Tax
- Basis
- Adjusted Basis
- Capital Improvements
- Capital Gain Tax
- Suspended Loss

Cost Recovery (AKA Depreciation)

This is the true tax shelter provided by investment real estate ownership it costs nothing yet reduces your annual tax liability

Cost recovery is taken on the value of the improvements only (land is not wearing out supposedly)

Cost Recovery is the governments way of saying that buildings don't last forever

<u>Residential Investment property</u> cost recovery allows the value of the improvements to be written off over a **<u>27.5 year</u>** period (regardless of the age of the building)

<u>Industrial/Office/Retail Investment property</u> cost recovery allows the value of the improvements to be written of over **<u>39 years</u>**

Calculating Cost Recovery

Residential Investment Property

Residential Investment Property 27.5 Years Straight Line Method

Original Basis

Less

Land Value

Equals

Improvement Value

Divide by

27.5

Equals

Annual Cost Recovery

Calculating Cost Recovery
Industrial/Office/Retail

Investment Property other than Residential 39 Years Straight Line Method

Original Basis

Less

Land Value

Equals

Improvement Value

Divide by

39

Equals

Annual Cost Recovery

Value of Cost Recovery

Cost Recovery shelters principal payments made on the loan first

Cost Recovery shelters positive income from operations

Cost Recovery can shelter income from other real estate investments

Cost Recovery can shelter income in the Active Category (wages etc…) within governmental limits

Cost Recovery is the one true tax shelter in Real Estate Investing

Tax Shelter Limits

Tax shelter of Active Income from Passive Activities is limited to $25,000 maximum with the following caveats

A) Active participation in Investment

B) 10% or greater ownership

C) Adjusted Gross Income (line 30 of form 1040) less than $100,000

In the event Adjusted Gross Income (AGI) exceeds $100,000 but is less than $150,000, tax shelter limit is reduced $0.50 for every $1.00 (1/2) of income greater than $100,000 AGI

e.g. AGI = $120,000 – $100,000 = $20,000 / 2 = $10,000 Tax Shelter Limit reduction

Tax shelter limit = $15,000

Basis

Original Basis

What I Paid

+ Cost to Purchase

Adjusted Basis

Original Basis

– Cost Recovery

+ Capital Improvements

= Adjusted Basis

Suspended Losses

Suspended Losses are losses created in the operation of a real estate investment that exceed the government imposed limits for tax shelters.

Suspended Losses are carried forward and used when possible

Suspended Losses reduce capital gain taxes owed at sale