

Real Estate Financial Reporting: Understand the Differences Between U.S. GAAP Versus Income Tax Basis Accounting; Then Choose the Option That's Best for Your Company

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U.S. generally accepted accounting principles and income tax basis accounting often yield very different financial reporting results; real estate companies need to understand what the choices mean for their business and apply what best serves their needs.

U.S. generally accepted accounting principles, also known as GAAP, is a common accounting method but is not the only choice for real estate companies that issue financial statements. Real estate owners should also consider how the use of the income tax basis for financial reporting would impact their reported financial results and balance sheet.¹ The income tax basis of accounting often produces reported financial results that are more closely aligned with certain economics of the business, particularly the cash flows associated with leases.

GAAP reporting would be required if the real estate entity is a public company, such as a publicly traded REIT, and would likely be required by institutional investors who are partners in a private real estate company. But when the entity's choice of accounting method is not dictated by governing bodies, real estate owners should be aware that

income tax basis financials might be a more useful management tool and provide greater transparency and insight into how the business is performing. This article will highlight some of the more common differences that occur in real estate financials when using GAAP vs. the accrual basis² of income tax basis reporting — not all of them, but rather those that are most likely to arise in the normal course of operations. It will discuss the impact the choice of accounting method will have on a real estate company's financial position and results of operations.

Impairment Charges

In contrast to the early 2000s when the market saw sales prices never before imaginable and financing transactions which assumed that real estate would continue to appreciate substantially, the current economic climate dictates that real estate companies

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must take a tough, hard look at the fair value of their real estate in light of current market conditions. Companies that prepare financial statements using GAAP must evaluate whether there has been impairment of their real estate, and if so, record an impairment charge in earnings. A real estate entity that holds property for long term use must determine if the undiscounted future net cash flows expected to be generated from the real estate are more than the property's carrying value (cost less accumulated depreciation). If the undiscounted future net cash flows are less than the carrying value, impairment must be recognized to reduce the carrying amount of the property to its fair value. Often, the fair value of the property would be based on discounting the future net cash flows used in determining if there is impairment under GAAP. There are, however, other methods for determining fair value including the use of comparable sales or capitalization "cap" rates.

For example, let's assume that in 2010 the undiscounted future net cash flows expected to be generated from a commercial property are \$30,000,000 and the carrying value of the property is \$50,000,000. These projections imply that the real estate is impaired and it must be written down to fair value. In order to calculate impairment, we will discount the cash flows to present value using an interest rate that is appropriate for the risks involved in generating the cash flows. If we assume that discounted cash flows are \$20,000,000, impairment charges amounting to \$30,000,000 ($\$50,000,000 - \$20,000,000$) must be recognized for GAAP in the company's 2010 results of operations and the real estate on the balance sheet must be reduced to \$20,000,000. If the property appreciates in value in the future, however, no write-up to fair value is allowed under current GAAP.³

On the other hand, for tax basis reporting, no impairment charges are allowed to be taken as real estate is generally required to be reported at cost less accumulated depreciation.

When impairment is required to be recorded, as in the example above, the impact to the bottom line on a GAAP financial statement could be significant and impairment charges are presented in the income statement as an ordinary expense, along with other operating expenses of the business; they are not extraordinary items that are segregated as a separately stated line item caption to distinguish it from the day-to-day recurring type expenses. Therefore, if a separate line item sub-total such as Operating Income (or a similar equivalent sub-total) is presented in the income statement, it must include the impairment charge. While a financial analyst calculating EBITDA would likely add back the impairment charge, it is technically not "depreciation" or "amortization"; therefore, when calculating certain financial covenants, including EBITDA, impairment will likely be included barring a special carve-out in the loan documents. A significant amount of time can be spent developing and fine tuning models used to test for impairment and often independent appraisals will be needed to satisfy third parties. Appraisals might even be needed in establishing whether the undiscounted future net cash flows exceed the carrying amount with respect to the assumptions used to calculate terminal value.

Rent Holidays and Rent Step-Ups

Applying GAAP, base rent is generally required to be recognized on a straight line basis over the life of the lease; thus, the same amount of rent is recognized each month

regardless of the amount the tenant is actually being billed and the cash flow the lease is generating. If a lease contains step-up provisions and/or free rent periods, the rent bumps and periods of rent holidays are factored into determining a constant rent each month throughout the life of the lease. For example, if a tenant has a three month

rent holiday at the beginning of its lease term of January 1, 2010 and pays \$100,000 per month in base rent for the remainder of its 10 year lease, using GAAP, \$1,170,000 in rent income would be recognized in the financials in Year 1 (2010) of the lease as follows:

Example 1

$\$100,000 \text{ per month} \times 117 \text{ months (120 mos. - 3 mos. free)} = \$11,700,000 \text{ total base rent to be billed over the lease life}$

Divided by 120 month lease life = \$97,500 rent recognized each month

$\$97,500 \text{ monthly rent} \times 12 \text{ months in Year 1 (2010)} = \$1,170,000 \text{ GAAP rent income}$

On the balance sheet at December 31, 2010, the difference between the rent billed (\$900,000) and the rent recognized as income (\$1,170,000) in Year 1 or \$270,000, would be recorded as a deferred rent asset. Beginning in Year 2 of the lease, the deferred rent asset would be reduced by \$30,000 per year until it is zero at the end of year 10. If the tenant terminates their lease early, the unamortized deferred rent asset must be written off upon termination.

If the income tax basis of accounting was used, the accounting treatment is generally simple: rent income reported on the financial

statements would be \$900,000 (\$100,000 per mo. billed \times 9 mos.) in Year 1 of the lease. Since the landlord actually billed \$900,000 and presuming that all rent was paid, the income reported is in sync with the \$900,000 of cash flow received from the tenant in 2010 and the amount of income the company will report on its 2010 income tax returns.

If we factor into the lease a rent step-up in Year 6 to \$105,000 per month, GAAP rent income in Year 1 of the lease would be \$1,200,000 as follows:

Example 2

$\$100,000 \times 57 \text{ mos.} + \$105,000 \times 60 \text{ mos.} = \$12,000,000 \text{ total base rent to be billed over the lease life}$

Divided by 120 month lease life = \$100,000 rent recognized each month

$\$100,000 \times 12 \text{ months in Year 1 (2010)} = \$1,200,000 \text{ GAAP rent income}$

However, for financials prepared using the income tax basis of accounting, rent income recognized in Year 1 of the lease would still be \$900,000, assuming that Internal Reve-

nue Code ("IRC") Section 467 provisions do not apply. In this example, we again see that using tax basis accounting mirrors the cash flows to be generated from the lease,

whereas GAAP produces “phantom income” of \$300,000 (\$1,200,000–\$900,000) in Year 1 of the lease. In Year 6 of the lease, GAAP rent income would remain at \$1,200,000 whereas tax basis rent income would be \$1,260,000 (\$105,000 per mo billed × 12 mos.).

Prepaid Rents

Sometimes (although not often enough for some real estate owners), tenants will prepay the succeeding year’s rent in advance of its due date. For instance, some tenants will pay rent due on January 1, 2010 in December 2009. If a real estate company reports on a calendar year using the income tax basis, the rent received in December 2009 would be reported as income when received in 2009. Thus, the cash flow mirrors the accounting treatment. For GAAP reporting, the income received in December 2009 would be recorded as deferred revenue on the balance sheet (essentially a liability) until it is earned under the terms of the lease in January 2010.

Allocation of Purchase Price for Income-Producing Real Estate

Prior to July 1, 2001, all real estate companies using either GAAP or income tax basis reporting typically allocated the purchase price of a income-producing property to the various tangible assets purchased, such as land, land improvements, building and personal property (i.e. furniture, fixtures and equipment) using appraised values, real estate tax assessed values, cost segregation studies, or some other rational allocation methodology. Real estate companies encountered a storm when, effective for real estate acquisitions post July 1, 2001, any company that reports using GAAP is required to allocate the purchase price of an income-producing property not only to the tangible

components purchased, but also to the intangible assets purchased including in-place leases and above and below market leases.

The rationale behind attributing value to in-place leases is that there is incremental value in a leased-up building versus an empty one, and this intangible value should be recognized separately. Such value includes, but is not limited to, the cost savings of not having to provide tenant improvement allowances to tenants that are already in the space or pay leasing commissions to secure a tenant. Similarly, there is value attributable to above market leases (the value is equal to the discounted cash flows of the above market leases in-place less the discounted market rate rents) which the buyer is paying for in the acquisition price, and there is negative value, if you will, associated with buying a property that has leases in-place that are below market value (negative value is equal to the difference between the discounted cash flows from the below market leases in-place and discounted market rate rents).

To illustrate the effect on a GAAP balance sheet and income statement, let’s assume that an owner purchases an income-producing commercial property as well as the underlying land for \$50,000,000 on January 1, 2010 and all of the in-place leases are at current market rents with the value of the in-place leases determined to be \$2,000,000. Since all of the leases are determined to be at current market rents, no value is attributed to above or below market leases. Based on comparable sales and other market factors, the value of the land is determined to be \$10,000,000 and the balance of the purchase price of \$38,000,000 is attributable to the building.

For GAAP purposes, the acquisition would be recorded on the balance sheet as follows:

Real Estate:	
Land	\$10,000,000
Building	<u>38,000,000</u>
Total Real Estate	\$48,000,000
Intangible Assets:	
Leases in-place	<u>2,000,000</u>
Total Acquisition Costs	<u>\$50,000,000</u>

If we further assume that the leases in-place have 5 year terms remaining on the acquisition date, for the year ended December 31, 2010, amortization of the leases in-place would be \$400,000 (\$2,000,000/5 years) and would be reflected as a reduction of rent income in 2010. When negotiating loan covenants, the debtor should pay careful attention to whether or not intangible assets are included as assets in any covenant calculations, as the value assigned to them can be significant.

Using the income tax basis of accounting, no portion of the purchase price is allocated to in-place or above/below market leases. Accordingly, the real estate buyer would report real estate assets totaling \$50,000,000 on its balance sheet, and there would be no reduction in rent income since there is no amortization of intangibles. Therefore, 2010 tax basis rent income would be \$400,000 higher than GAAP rent income but there would be additional depreciation expense on the building due to its higher carrying value for tax reporting purposes.

If the real estate buyer purchased a property that has leases in-place with rates of \$50 psf and \$75 psf when market rates for similar leases in a like-kind property are at \$60 psf, part of the purchase price must be

allocated to those leases that are above market value (\$75 psf leases) and below market value (\$50 psf leases). The value attributed to above market value leases (\$75 psf - \$60 psf = \$15 psf discounted to present value) are reported as intangible assets on the balance sheet while the value attributed to below market leases (\$60 psf - \$50 psf = \$10 psf discounted to present value) is shown as deferred revenue, an intangible liability.

Similar to leases in-place, both above and below market leases are amortized over their remaining lease terms, with the amortization either increasing rent income (below market lease) or decreasing rent income (above market lease). If a tenant terminates their lease prior to expiration, the unamortized intangible asset or liability is written off to rent income upon termination. Clearly, the income tax basis of accounting is much easier to apply and track as it relates to acquisition costs, (and consequently, is less costly to administer) and results in rent income that is more closely aligned with the cash flows associated with leases.

Depreciation

For those entities that report using GAAP, depreciation of property such as building and

equipment are generally calculated using the straight line method or some other systematic approach over the estimated useful life of the asset. If sometime down the road the estimated useful life of the asset has changed, GAAP would require that the carrying value of the asset be depreciated using the new estimated life. For example, depreciation on a commercial building that is purchased on January 1, 2010 for \$10,000,000 and has an estimated remaining useful life of 20 years would be \$500,000 ($\$10,000,000/20$ years) in calendar year 2010 using GAAP. For income tax basis reporting purposes, the IRC requires that statutory lives, methods and conventions be used to depreciate assets. The statutory life for a commercial property purchased in 2010 is 39 years. Thus, depreciation for 2010 for tax basis reporting would be approximately \$246,000 (MACRS mid-month convention=2.461%) or \$254,000 less than GAAP depreciation.

If the building was residential, for tax purposes, depreciation would be calculated using a 27.5 year life, but the same 20 year useful life would be used for GAAP reporting purposes. Hence, the tax basis method ignores the fact that at the end of 20 years, the building is likely to need a major overhaul as it has likely reached the end of its useful life in its present condition. Moreover, tenant improvements are required to be depreciated for GAAP purposes over the shorter of the assets' useful life or the life of the related tenant's lease (generally excluding exercise option periods).

Let's assume that on March 1, 2010, a landlord completes a fit-out of a tenants' space by installing a staircase to make two floors accessible from inside and constructs permanent walls to create additional offices

(these are considered structural components). The costs of this work amount to \$2,000,000 and the useful lives of the assets constructed are estimated at 20 years. The tenant has a lease with a 10 year term. Depreciation would be calculated using a 10 year life (the shorter of the useful life or the life of the lease) for GAAP purposes and amount to \$166,667 ($\$2,000,000/120$ mos. $\times 10$ mos.) in 2010.

For tax purposes, the tenant improvements would be depreciated over their statutory lives of 39 years (mid-month convention) for a commercial building and amount to \$40,660 (assuming the improvements do not qualify as 15 year leasehold improvement property). As we can see, the difference in the lives used to compute depreciation under GAAP versus income tax basis accounting yields GAAP depreciation expense that is almost four times greater than income tax depreciation deductions. Further, if the tenant vacates the space before their lease expires, for GAAP reporting, the undepreciated improvements would be written off to expense at the time the tenant vacates. For tax reporting, if the tenant vacates the space but the assets are left in service for a new tenant that moves in, the assets would continue to be depreciated over their remaining statutory tax lives. While EBITDA excludes depreciation charges, the higher depreciation charges increase the amount of accumulated depreciation and reduce the carrying value of the real estate and equity reported on the balance sheet. This will impact certain covenant calculations including debt-to-equity ratios.

Over the years, the IRC has also provided for other accelerated depreciation deductions for certain assets such as "bonus depreciation" and IRC Section 179 deductions, whereas no such like-kind depreciation deductions apply for GAAP.

Related Party Transactions

It is common in the industry for real estate owners to have affiliated companies that provide management, leasing, cleaning and other types of services for the property. Often, these types of service businesses have elected for income tax return purposes to use the cash basis of accounting. If a real estate company prepares its financial statements using the accrual income tax basis of accounting, expenditures incurred for services rendered by a cash basis related party that have not yet been paid to the related party, cannot be deducted on the company's income tax basis financials until paid. The rationale for the tax treatment among related party transactions is that one party should not be allowed to claim tax deductions until the counterparty has recognized the related income.

For instance, if November and December 2010 management fees amounting to \$60,000 were not paid to a cash basis affiliate by the real estate reporting company's December 31, 2010 year-end, those management fees could not be deducted on the real estate company's 2010 income tax-basis financials. If the real estate company reported under GAAP, the \$60,000 would be deducted as an expense on the 2010 financials. In this situation, for tax basis-reporting, the timing of payment determines when the amounts can be deducted on the financials. This can result in distortions in the income statement because services have been rendered without the related expense being recognized. GAAP on the other hand, provides for a matching of the expense in the same period that the services were rendered.

Organization Costs

Costs of forming a business, such as legal

fees for drafting of documents, state filing fees, and accounting costs incident to organization, are treated very differently for GAAP and income tax reporting purposes. For GAAP, organization costs must be expensed in the year the business begins. Post October 22, 2004, for tax basis reporting, a business can elect (but is not required) to deduct up to \$5,000 in organization costs in the tax year in which the business began (subject to a dollar for dollar phase-out when organization costs exceed \$50,000) and the balance must be amortized over a 180 month period. If a real estate company began business on January 1, 2010 and incurred \$100,000 in organization costs, for GAAP purposes, \$100,000 of organizational expenditures would be deducted on the income statement in 2010. For 2010 tax reporting purposes, \$6,667 ($\$100,000 \times 12 \text{ mos.} / 180 \text{ mos.}$) of amortization expense related to organization costs would be deducted in the income statement, and organization costs net of accumulated amortization amounting to \$93,333 ($\$100,000 - \$6,667$) would be reported on the December 31, 2010 balance sheet. For GAAP, no asset would be recorded, as the expenditure is deducted in full in the year business began.

Why Don't More Real Estate Companies Use The Income Tax Basis for Financial Reporting?

Real estate reporting entities sometimes feel compelled to use GAAP — even when they don't have to. When negotiating financing for the first time or with a new lender, the boilerplate loan documents produced by the lender will almost always state that the financial statements should be prepared in accordance with GAAP. But this clause is negotiable. If the debtor says that the company prefers to use the income tax basis of

accounting for financial reporting purposes, in the vast majority of cases, the lender will acquiesce, without so much as a blink of the eye. A person negotiating a loan for the first time or with a new lender might not know this, and might not know that all you need to do is ask. In my experience, I have rarely encountered a situation where a lender said no to income tax basis reporting.

Carefully Analyze the Effects on Loan Covenants When Choosing GAAP or Income Tax Basis Reporting

Using GAAP versus income tax basis accounting could also have a material impact on loan covenants such as debt service coverage and debt-to-equity ratios, along with EBITDA. As illustrated above, your choice of accounting method not only can impact your income statement, it can have dramatic results on the balance sheet, as well. Prior to adopting a method of accounting, in addition to your cash flow and income projections, you should also prepare projections of your financial covenants to ensure that you will be able to meet all of them given your choice of accounting method for financial reporting.

Real Estate Owners Should Weigh The Options. Income Tax Basis Accounting Is Useful In Many Situations. At Other Times, GAAP Might Be the Preferred Route

Where there are leases with step-ups, free rent periods and/or in years where many tenants pre-pay the following year's rent, income tax basis accounting generally provides a clearer portrait of the economic realities of the company's cash flows and the accounting is aligned with the income that will be reported on the company's tax returns. In addition, if the income tax basis is used for

reporting, there is a cost saving that results from not having to produce two sets of books and records — one for preparing the company's income tax returns and another for GAAP. Moreover, much of the information that is needed in the application of GAAP, such as detailed valuations of leases, impairment testing and straight line rent calculations, are often very complex and costly to perform, not to mention audit, if an audit is required.

On the other hand, using GAAP for financial reporting results in depreciation charges that are recognized over an asset's useful life, instead of an arbitrary statutory life determined by the Internal Revenue Service, and real estate will be reduced to fair value when impairment has occurred.

Also keep in mind when choosing a method of accounting that just when you thought you knew all there was to know about reporting under U.S. GAAP, in the next few years, International Financial Reporting Standards ("IFRS") may entirely replace U.S. GAAP reporting as we know it today. The preparation of financial statements using IFRS would generally be more complex and would require substantially more footnote disclosures than under U.S. GAAP.

There's no across-the-board answer to which accounting method might work best for a real estate company. The choice depends on each real estate owner's business situation. However, income tax-basis accounting is something that every real estate entity should consider if the choice is available as it's often easier and less costly to apply, and usually produces financial reporting results that are generally more closely tied to the economic aspects of the business that are of greatest concern to private owners and lenders.

Illustration of Accounting Effects on Balance Sheet and Income Statement

Assumptions:

On January 1, 2010, land and a fully oc-

cupied commercial building were purchased for \$50,000,000. The partners in a partnership made capital contributions in the amount of \$45,000,000 and obtained a mortgage in the amount of \$10,000,000.

Allocation of purchase price:	Tax	GAAP
Land	\$10,000,000	\$10,000,000
Building	40,000,000	39,000,000
Leases in-place	NA	2,000,000
Above market leases	NA	3,000,000
Below market leases	NA	(4,000,000)
Total Acquisition Cost	<u>\$50,000,000</u>	<u>\$50,000,000</u>
Estimated remaining useful life of building	39 years, mid-month convention (IRC statutory rate=2.461%)	20 years

Leases in-place:	
Commencement dates	January 1, 2010
Term	10 years
Rents	
Years 1-5	\$1,200,000 per yr./ \$100,000 per mo.
Years 6-10	\$1,260,000 per yr./\$105,000 per mo.
Free Rent	January 1, 2010-March 31, 2010 (3 mos.)

Other 2010 Transactions:	
2011 rents prepaid in 2010	\$500,000
Organization costs incurred and paid-legal and accounting	\$100,000
Related party management fees incurred in 2010, unpaid at December 31, 2010	\$60,000
March 31, 2010-Tenant improvement work completed, paid and placed in service-structural components (not eligible for 15 year "qualified leasehold improvement" treatment)	\$2,000,000, estimated useful life of 20 yrs.
Mortgage closing costs paid by partner capital contributions	\$400,000
Mortgage payable	Term-10 years, interest only at 5% per annum
Operating expenses incurred and paid in 2010 (excluding management fees)	\$300,000

Differences Between U.S. GAAP Versus Income Tax Basis Accounting

Table 1-Journal Entries for 2010 Transactions Using Income Tax Basis and GAAP

F/S=Financial Statement

BS=Balance Sheet

IS=Income Statement

Journal Entries	F/S	Tax	GAAP
		Debit (Credit)	
1-Record acquisition of property:			
Cash	BS	5,000,000	5,000,000
Land	BS	10,000,000	10,000,000
Building	BS	40,000,000	39,000,000
Leases in-place	BS	NA	2,000,000
Above market leases	BS	NA	3,000,000
Below market leases	BS	NA	(4,000,000)
Mortgage payable	BS	(10,000,000)	(10,000,000)
Capital contributions-partner's equity	BS	(45,000,000)	(45,000,000)
2-Record 2010 depreciation on building:			
Depreciation expense:			
Tax(\$40,000,000 × 2.461% statutory rate)	IS	984,400	
GAAP(\$39,000,000/20 yr. useful life)	IS		1,950,000
Accumulated depreciation	BS	(984,400)	(1,950,000)
3-Record amortization of intangible lease assets and liabilities:			
Leases in-place:			
Rent income (\$2,000,000/ 10 yrs)	IS	NA	200,000
Accretion-leases in-place	BS	NA	(200,000)
Above market leases:			
Rent income (\$3,000,000/ 10 yrs)	IS	NA	300,000
Accretion-above market leases	BS	NA	(300,000)
Below market leases:			
Rent income (\$4,000,000/ 10 yrs)	IS	NA	(400,000)
Accretion-below market leases	BS	NA	400,000
4-Record 2010 rent billings per leases (assume all collected):			
Cash	BS	900,000	900,000
Rent income	IS	(900,000)	(900,000)
5-Record 2010 straight line rent adjustment:			
Deferred rent receivable(\$1,200,000 s/l-\$900,000 billed)	BS	NA	300,000
Rent income	IS	NA	(300,000)
(See Example 2 in article above)			

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<u>Journal Entries</u>	<u>F/S</u>	<u>Tax</u>	<u>GAAP</u>
		<u>Debit (Credit)</u>	
6-Record 2011 rents prepaid in 2010:			
Cash	BS	500,000	500,000
Rent income	IS	(500,000)	NA
Deferred revenue(prepaid rent)	BS	NA	(500,000)
7-Record organization costs and 2010 amortization:			
Organization costs	BS	100,000	NA
Cash	BS	(100,000)	(100,000)
Professional fees	IS	NA	100,000
Amortization expense (\$100,000/180 mos. × 12 mos.)	IS	6,667	NA
Accumulated amortization-organization costs	BS	(6,667)	NA
8-Record related party (cash basis taxpayer) management fees incurred in 2010 but not yet paid at 12/31/10:			
Management fees	IS	NA	60,000
Accrued expenses	BS	NA	(60,000)
9-Record 3/1/10 tenant improvements placed in service and 2010 depreciation:			
Tenants improvements	BS	2,000,000	2,000,000
Cash	BS	(2,000,000)	(2,000,000)
Depreciation expense:			
Tax (\$2,000,000 × 2.033% statutory rate)	IS	40,660	
GAAP (\$2,000,000/120 mo. lease life × 10 mos.)	IS		166,667
Accumulated depreciation-tenant improvements	BS	(40,660)	(166,667)
10-Record payment of -and amortization on-mortgage closing costs:			
Deferred financing costs	BS	400,000	400,000
Capital contributions-partner's capital	BS	(400,000)	(400,000)
Amortization expense-deferred financing costs (\$400,000/10 yrs.)	IS	40,000	40,000
Accumulated amortization-deferred financing costs	BS	(40,000)	(40,000)
11-Record interest incurred and paid on mortgage:			
Interest expense (10,000,000 × 5%)	IS	500,000	500,000
Cash	BS	(500,000)	(500,000)
12-Record operating expenses paid in 2010:			
Operating expenses	IS	\$300,000	\$300,000
Cash	BS	(300,000)	(300,000)

Differences Between U.S. GAAP Versus Income Tax Basis Accounting

Table 2-Financial Reporting-Balance Sheet at December 31, 2010

Assets	Tax	GAAP
Real Estate:		
Land	\$10,000,000	\$10,000,000
Building, net of accumulated depreciation	39,015,600	37,050,000
Tenant improvements, net of accumulated depreciation	1,959,340	1,833,333
Real Estate, net	\$50,974,940	\$48,883,333
Cash	3,500,000	3,500,000
Deferred rent receivable	-	300,000
Intangible Assets:		
Organization costs, net of accumulated amortization of \$6,667	93,333	-
Deferred financing costs, net of accumulated amortization of \$40,000	360,000	360,000
Leases in-place, net of accretion of \$200,000	-	1,800,000
Above market leases, net of accretion of \$300,000	-	2,700,000
Intangibles Assets, net	453,333	4,860,000
Total Assets	\$54,928,273	\$57,543,333
Liabilities		
Mortgage payable	\$10,000,000	\$10,000,000
Accrued expenses	-	60,000
Deferred revenue (prepaid rent)	-	500,000
Deferred revenue(below market leases, net of accretion of \$400,000)	-	3,600,000
Total Liabilities	\$10,000,000	\$14,160,000
Partner's Capital	44,928,273	43,383,333
Total Liabilities and Partner's Capital	\$54,928,273	\$57,543,333
Debt-to-equity ratio(No carve-out for intangible below-market leases):		
Total liabilities/Partner's capital	.23	.33
Long term debt/Partner's capital	.22	.23

Table 3-Financial Reporting-Income Statement for the Year Ended December 31, 2010

	<u>Tax</u>	<u>GAAP</u>
Revenues:		
Rent income (1)	\$1,400,000	\$1,100,000
Expenses:		
Operating expenses	300,000	300,000
Management fees	-	60,000
Professional fees(organization costs)	-	100,000
Interest expense	500,000	500,000
Expenses Before Depreciation and Amortization	<u>800,000</u>	<u>960,000</u>
Income Before Depreciation and Amortization	600,000	140,000
Depreciation and Amortization:		
Building	984,400	1,950,000
Tenant improvements	40,660	166,667
Organization costs	6,667	-
Deferred financing costs	40,000	40,000
Depreciation and Amortization	<u>1,071,727</u>	<u>2,156,667</u>
Net Income (Loss)	<u>\$(471,727)</u>	<u>\$(2,016,667)</u>
EBITDA	\$1,100,000	\$640,000
Debt Service Coverage Ratio:		
Net Operating Income (NOI)/Total Debt Service	2.2	1.28

<u>Journal Entry</u>	<u>(1) Rent Income</u>	<u>Tax</u>	<u>GAAP</u>
4 2010 Rent Billings		\$900,000	\$900,000
6 2011 Rent prepaid in 2010		500,000	-
5 Straight line rent adjustment		-	300,000
3 Amortization-in-place leases		-	(200,000)
3 Amortization-above market leases		-	(300,000)
3 Amortization-below market leases		-	400,000
Total Rent Income		\$1,400,000	\$1,100,000

NOTES:

¹The appropriate titles for a balance sheet and income statement that are prepared using the income tax basis of accounting are Statement of Assets, Liabilities and Equity and Statement of Revenues over Expenses (or a similar nomenclature), respectively. For ease of reading, the titles used in this article are the titles used on financial statements prepared using U.S. GAAP.

²There would be many additional differences between GAAP and *cash* basis income tax basis reporting; however, lenders and other users are much less likely to accept the cash basis of income tax reporting so they will be excluded from this article.

³On August 17, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued an exposure draft on proposed new leasing and investment property standards. Under the proposed standards, investment prop-

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erties would be reported at fair value which could result in write-ups as well as write-downs from carrying value.