

Business 850: Real Estate Equity Investment. 1976-1988

Graaskamp, James A.
[s.l.]: [s.n.], 1976-1988

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Business 850
REAL ESTATE EQUITY INVESTMENT

Fall 1976

Prof. James A. Graaskamp
Lect. Michael L. Robbins

I. Objectives

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

II. General Course Format

Each week will have selected readings which are required. There will be a lecture on Mondays which, hopefully, will shed some light and organization on the readings selected. On Wednesdays, there will be a lab session devoted to problem technique. There will be a 2-hour exam at mid-semester and another at the end of the semester on these readings, and these exams will be 50% of your grade.

There will be a series of problem exercises, including several computer terminal lab sessions which will represent 20% of your grade.

Finally each student will do two intensive case problem studies and your case study presentations and written report will be 30% of your grade.

III. Textbooks

Recommended for purchase:

Federal Taxes Affecting Real Estate, Arthur Anderson, Farm Land & Brokers Institute, Chicago (\$8.25)

Real Estate Securities & Syndications - A Workbook, Stephen Roulac, Real Estate Securities & Syndication Institute (\$8.25)

Mimeograph package - \$15.00

Books and mimeos can be purchased for cash from the University of Wisconsin Real Estate Club in Room 118 at the prices indicated. No credit.

NOTE: ALL PAPERS AND EXERCISES TO BE HANDED IN SHOULD BE STAPLED AT UPPER LEFT HAND CORNER AND GIVEN A TITLE PAGE BUT LEFT WITHOUT PLASTIC BINDERS OR OTHER SIMILAR COVERS.

850 TIMETABLE

Wed. Sept. 8	The Introduction - Definition of Real Estate Equity
Mon. Sept. 13	Evolution of Income Property Analysis
Wed. Sept. 15	Basic Cash Flow and MR. CAP
Mon. Sept. 20	Commercial Methods of Property Analysis
Wed. Sept. 22	Exercise #1, MR. CAP
Mon. Sept. 27	Advanced Methods of Real Estate Equity Analysis
Wed. Sept. 29	Exercise #2, MR. CAP
Mon. Oct. 4 & 11	Real Estate and the Federal Income Tax
Wed. Oct. 6	Exercise #3, MR. CAP
Tues. Oct. 12 & Wed. Oct. 13 (afternoons & evenings)	(Computer Terminal Labs to be held in split sections in Lowell Hall)
Mon. Oct. 18	Estate Planning & Real Estate Investment
Wed. Oct. 20, Mon. Oct. 25	Limited Partnerships
Wed. Oct. 27	Exercise #4, MR. CAP
Mon. Nov. 1 & Wed. Nov. 3	Joint Ventures
Mon. Nov. 8	Real Estate as a Security
Wed. Nov. 10	TWO HOUR WRITTEN MID-SEMESTER EXAM
Mon. Nov. 15 Wed. Nov. 17	Real Estate Investment Trusts (Portfolio Selection of Trust Shares Case Due Nov. 15)
Mon. Nov. 22	Land and Farm Investment
Wed. Nov. 24	Equity Investment Strategy CASE PROBLEM DUE - in class (Late papers penalized 20%)
Mon. Nov. 29	Tax Deferred Exchanges of Real Estate
Wed. Dec. 1	Real Estate Stocks
Mon. Dec. 6	Other Tax Shelter Deals - Oil and Cattle
Wed. Dec. 8	Case Presentations Review
Mon. Dec. 13	TWO HOUR WRITTEN EXAM

Business 850 - Fall 1976

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
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	A. "Dr. Pond and the State of the Literature in Real Estate Analysis and Valuation," Michael Hanrahan, Dec. 1975	Mimeo
	B. "Caveat Emptor in Real Estate Equities," Hayes & Harlan, <u>Harvard Business Review</u> , Mar.-April 1972	Mimeo
	C. "A Rational Approach to Feasibility Analysis," James A. Graaskamp, Chap. 3	Mimeo
	D. "Financial Analysis of Real Property Investments," Harvard Business School	Mimeo
	E. "Using the Discounted Yield to Compare Real Estate Alternatives," Robert Ellis, Coldwell Banker	Handout
	F. "Leverage in Real Estate," Stanford University, Graduate School of Business	Mimeo
Mon. Sept. 13	EVOLUTION OF INCOME PROPERTY ANALYSIS	
	A. "Real Estate Financial Analysis - The State of the Art," Oakleight J. Thorne, <u>Appraisal Journal</u> , January 1974	Mimeo
	B. "How Should Yield be Measured in Real Estate Investment?," James R. Cooper, Part 1 & Chap. 1	Mimeo
	C. "How to Assess Investment Proposals," Robert H. Baldwin, <u>Harvard Business Review</u> , May-June 1957	Mimeo
	D. "Differences Between the Major Discounted Cash Flow Capital Budgeting Techniques, Chap. 3, pp. 45-63, Eugene Brigham, <u>Readings in Managerial Finance</u>	Mimeo
	E. "Real Estate Investment Analysis: IRR Versus FMRR," Steven Messner & M.C. Findlay III, <u>Real Estate Appraiser</u> , July-Aug. 1975	Mimeo
Wed. Sept. 15	BASIC CASH FLOW AND MR. CAP	
	A. Review of MR. CAP Manual	

- Mon. Sept. 20 COMMERCIAL METHODS OF PROPERTY ANALYSIS
- A. Property Analysis Forms, NIREB Mimeo
 - B. "Peril-Point Acquisition Prices," John F. Crowther, Harvard Business Press, Sept.-Oct. 1969 Mimeo
 - C. Omnimetrics - Income Property Investment Analysis Model Mimeo
 - D. The Prudential Insurance Co. Model Mimeo
 - E. "California CPA Foundation Course on Real Estate Syndication," John Greiner, Economic Research Association Mimeo
 - F. RAM-30 Model - Arthur Young and Co. Mimeo
- Mon. Sept. 27 ADVANCED METHODS OF REAL ESTATE EQUITY ANALYSIS
- A. "Contemporary Decision Theory and Real Estate Investment," Richard U. Ratcliff & Bernhard Schwab Mimeo
 - B. "A Computer Simulation Model to Measure the Risk in Real Estate Investment," Steven Phyr, Chap. 13 Mimeo
 - C. "Beta Mousetrap?" Thomas, Barrons, 2/7/72 Mimeo
 - D. "The Analysis of Real Estate Investments Under Uncertainty," Peter K. Pellatt Mimeo
- Mon. Oct. 4 REAL ESTATE AND THE FEDERAL INCOME TAX
- A. Federal Taxes Affecting Real Estate, Chapters 1,2,3,4,5, & 12 Text
 - B. "Changes in Depreciation and Recapture - Impact on Real Estate Investments," Emil Sunley, Appraisal Journal, October 1970 Mimeo
 - C. "Real Estate and Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act," Ritter & Sunley, Maryland Law Review, Winter 1970 Mimeo
- Mon. Oct. 11 REAL ESTATE AND THE FEDERAL INCOME TAX
- A. Federal Taxes Affecting Real Estate, Chapters 6,7,8,9,10, & 11 Text
 - B. Proposed Tax Reform - Inconsistent with National Housing Policy," Stephan Roulac, The Appraisal Journal, April 1974 Mimeo
 - C. "Some Overlooked Aspects of Artificial Accounting Losses, Limited Partnerships & Tax Reduciton," Brueggeman & Greenwood Mimeo

Mon. Oct. 18

ESTATE PLANNING & REAL ESTATE INVESTMENT

- A. Federal Taxes Affecting Real Estate, Chap. 14 Text
- B. "Introductory Orientation on the Estate Planning Art," Casey, Institute for Business Planning Mimeo
- C. Section 1: Inheritance and Estate Tax - Wis. CLEW Mimeo
- D. Kersten v. Wis. Department of Revenue - March 1976 Mimeo
- E. "Andorra is the Ultimate in Tax Shelters" Mimeo

Wed. Oct. 20

LIMITED PARTNERSHIPS

- A. Real Estate Securities and Syndication Workbook, Stephan Roulac, Chapters 1-14. Scan 4,5,7,13 Roulac text
- B. "How to Form the Perfect Syndicate," Real Estate Mortgage Newsletter Mimeo
- C. "Case Study of a Private Real Estate Syndication" Mimeo

Mon. Oct. 25

LIMITED PARTNERSHIPS

- A. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems," Stephan Roulac, Real Property, Probate and Trust Journal, Summer 1975 Mimeo
- B. "Proposed Statement of Policy for Intra-State Partnerships," State of Michigan Mimeo
- C. Appendix B, McNeil Pacific Investors Fund Prospectus Roulac text

Mon. Nov. 1

JOINT VENTURES

- A. "Real Estate Equity Investments," and "The Institutional Lender; Nothing Ventured Nothing Gained," F.E. Rogge, G.J. Talbot, R.M. Zinman, Fordham Law Review, Vol. 39, May 1971 Mimeo
- B. "Introduction to Taxation and Other Legal Problems of Unincorporated Real Estate Entities," Martin B. Cowan, Joint Ventures in Real Estate - 2D, Practising Law Institute Mimeo
- C. "How to Account for Real Estate Joint Ventures," James J. Klink, Real Estate Review, Spring 1974 Mimeo

Mon. Nov. 8

REAL ESTATE AS A SECURITY

- A. "Securities Act Release #5465," Tax Shelters,
PLI, pp. 137-152 Mimeo
- B. "SEC Disclosure Practices in Tax Sheltered
Offerings," Barry Thorpe, Real Estate Law
Journal, Special Supplement Mimeo
- C. "The Impact of Securities Regulations and Fi-
nancial Reporting Responsibilities on Real
Estate Investment, Stephen Roulac Mimeo

Wed. Nov. 10

TWO HOUR WRITTEN MID-SEMESTER EXAM

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Mon. Feb. 7	Advanced Methods of Real Estate Equity Analysis
Wed. Feb. 9	Exercise #1 - MR. CAP
Mon. Feb. 14	Introduction to Equity Risk Analysis
Wed. Feb. 16	Exercise #2 - MR. CAP
Feb. 21 & 23	Real Estate and the Federal Income Tax
Feb. 28 & Mar. 1	Computer Terminal Labs to be Held in Split Sections in Lowell Hall (afternoons and evenings)
Mon. Mar. 7	Estate Planning & Real Estate Investment
Wed. Mar. 9	Estate Planning Cont'd.
Mar. 14 & 16	Limited Partnerships
Mar. 21 & 23	Joint Ventures
Mon. Mar. 28	Exercise #3 - MR. CAP
Wed. Mar. 30	TWO-HOUR MID-SEMESTER EXAM
Apr. 11 & 13	Real Estate as a Security
Mon. Apr. 18	Real Estate Investment Trusts
Wed. Apr. 20	Condominiums as a Real Estate Investment
Mon. Apr. 25	Land and Farm Investments
Wed. Apr. 27	Tax-Deferred Exchanges of Real Estate
Mon. May 2	Real Estate Investment Strategy
Wed. May 4	Case Problem Due in Class (Late Papers Penalized 20%)
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Wed. Jan. 26	EVOLUTION OF INCOME PROPERTY YIELD ANALYSIS	
	A. "Real Estate Financial Analysis - The State of the Art," Oakleigh J. Thorne, <u>Appraisal Journal</u> , Jan. 1974	Mimeo
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	A. Property Analysis Forms, NIREB	Mimeo
	B. "Peril-Point Acquisition Prices," John F. Crowther, Harvard Business Press, Sept.-Oct. 1969	Mimeo
cont'd.	C. "Real Estate Investment Analysis: An Empirical Study," Robert J. Wiley, <u>The Appraisal Journal</u> , Oct. 1976	Mimeo

	D. DAP Manual, John Nabors	Mimeo
	E. "California CPA Foundation Course on Real Estate Syndication," John Greiner, Economic Research Association	Mimeo
	F. RAM - 30 Model - Arthur Young and Co.	Mimeo
Wed. Feb. 2	BASIC CASH FLOW & MR. CAP	
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	A. "Contemporary Decision Theory and Real Estate Investment," Richard U. Ratcliff & Bernhard Schwab	Mimeo
	B. "A Computer Simulation Model to measure the Risk in Real Estate Investment," Steven Phyr, Chap. 13	Mimeo
	C. "The Analysis of Real Estate Investments Under Uncertainty," Peter K. Pellatt	Mimeo
Wed. Feb. 9	EXERCISE #1 - MR. CAP	
Mon. Feb. 14	INTRODUCTION TO EQUITY RISK ANALYSIS	
	A. "Evaluating Risk in Real Estate Investments," Michael Young	Mimeo
	B. "A Framework and Computer Model for Risk Analysis and Risk Management in Real Property Development," Mike Miles	Mimeo
	C. "The Reasons Behind the Real Estate Crash: A Case Study," Howard H. Stevenson, <u>Real Estate Review</u>	Mimeo
Wed. Feb. 16	EXERCISE #2 - MR. CAP	
Mon. Feb. 21	REAL ESTATE AND THE FEDERAL INCOME TAX	
	A. <u>Federal Taxes Affecting Real Estate,</u> Chpters 1, 2, 3, 4, 5, & 12	Text
	B. "Changes in Depreciation and Recapture - Impact on Real Estate Investments," Emil Sunley, <u>Appraisal Journal</u> , Oct. 1970	Mimeo
	C. "Real Estate and Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act," Ritter & Sunley, <u>Maryland Law Review</u> , Winter 1970	Mimeo
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	cont'd.	

- B. "Proposed Tax Reform - Inconsistent With National Housing Policy," Stephen Roulac, The Appraisal Journal, April 1974 Mimeo
- C. "Some Overlooked Aspects of Artificial Accounting Losses, Limited Partnerships & Tax Reduction," Brueggeman & Greenwood Mimeo

Mon. Feb. 28

LOWELL HALL EDUCARE SESSION

Wed. Mar. 1

" " " "

Mon. Mar. 7

ESTATE PLANNING & REAL ESTATE INVESTMENT

- A. Federal Taxes Affecting Real Estate, Chap. 14 Text
- B. "Introductory Orientation on the Estate Planning Art," Casey, Institute for Business Planning Mimeo
- C. Section 1: Inheritance and Estate Tax - Wis. ^{AL} CLEW Mimeo
- D. Kersten V. Wis. Department of Revenue - March 1976 Mimeo
- E. "Andorra is the Ultimate in Tax Shelters" Mimeo

Wed. Mar. 9

ESTATE PLANNING CONT'D.

- A. "Choosing Appropriate Estate Planning Tools: A Goal Oriented Matrix Approach," John R. Graham, CLU Journal Mimeo
- B. "Estate Planning for Farmers & Ranchers," Donald H. Kelley, The Practical Lawyer, Feb. 1974 Mimeo
- C. Mimeo

Mon. Mar. 14

LIMITED PARTNERSHIPS

- A. Real Estate Securities and Syndication Workbook, Stephen Roulac, Chapters 1-14. Scan 4, 5, 7, 13 Roulac Text
- B. "How to Form the Perfect Syndicate," Real Estate Mortgage Newsletter Mimeo
- C. "Case Study of a Private Real Estate Syndication" Mimeo

Wed. Mar. 16

LIMITED PARTNERSHIPS

- A. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems," Stephen Roulac, Real Property, Probate and Trust Journal, Summer 1975 Mimeo
- cont'd.

- B. "Proposed Statement of Policy for Intra-State Partnerships," State of Michigan Mimeo
- C. Appendix B, McNeil Pacific Investors Fund Prospectus Roulac Text

Mon. Mar. 21

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- C. "How to Account for Real Estate Joint Ventures," James J. Klink, Real Estate Review, Spring 1974 Mimeo

Wed. Mar. 23

JOINT VENTURES CONT'D.

Mon. Mar. 28

EXERCISE #3 - MR. CAP

Wed. Mar. 30

TWO-HOUR MID-SEMESTER EXAM

Mon. Apr. 11

REAL ESTATE AS A SECURITY

- A. "Securities Act Release #5465," Tax Shelters, PLI, pp. 137-152 Mimeo
- B. "SEC Disclosure Practices in Tax Sheltered Offerings," Barry Thorpe, Real Estate Law Journal, Special Supplement Mimeo
- C. "The Impact of Securities Regulations and Financial Reporting Responsibilities on Real Estate Investment," Stephen Roulac Mimeo

Wed. Apr. 13

REAL ESTATE AS A SECURITY CONT'D.

Mon. Apr. 18

REAL ESTATE INVESTMENT TRUSTS

- A. "NAREIF Handbook of Member Trusts," National Association of Real Estate Investment Funds, 1970 Mimeo
- B. "Conflict of Interest Problems in the Management of REIT's," Douglas W. Duval, Real Estate Law Journal, Summer 1974 Mimeo
- C. "Tax Problems of Mortgage Investment Trusts," Robert B. Klein Mimeo
- D. "Lessons From the Mortgage Trust Experience," Howard H. Stevenson, Real Estate Review, Fall 1976 Mimeo

Wed. Apr. 20

CONDOMINIUMS AS A REAL ESTATE INVESTMENT

- A. Pages 12-43, Commercial & Industrial Condominiums, John C. Melaniphy, Jr., a special report by the Urban Land Institute, 1976 Mimeo
- B. "Condominiums As Securities: A Current Look," David Clurman, New York Law Forum, Vol. 19, 1974 Mimeo
- C. "Condominium Regulation: Beyond Disclosure," University of Pennsylvania Law Review, Vol. 123:639, 1975 Mimeo

Mon. Apr. 25

LAND AND FARM INVESTMENTS

- A. "Preliminary Remarks: Farmland," unpublished material by James Ablan & James Graaskamp, April 1976 Mimeo
- B. Federal Taxes Affecting Real Estate, Chap. 10 Text
- C. Federal Taxes Affecting Real Estate, Chap. 14, Sections 14.05, 14.08, 14.09 Text

Wed. Apr. 27

TAX-DEFERRED EXCHANGES OF REAL ESTATE

- A. "Comments on Tax-Deferred Exchanges of Real Estate," Henry J. Olivieri, Jr. & Robert H. Johnson, Real Estate Investment Analysis, by James R. Cooper, Chap. 9, D.C. Heath and Co. Lexington, Mass. 1974 Mimeo
- B. Federal Taxes Affecting Real Estate, Chaps. 7 & 8 Text

Mon. May 2

REAL ESTATE INVESTMENT STRATEGY

- A. "Can Real Estate Returns Outperform Common Stocks?" Stephen Roulac, The Journal of Portfolio Management, Winter 1976 Mimeo
- B. "Commitment Planning: An Approach to Reducing Real Estate Risks," by Mahlon Apgar, IV, The Appraisal Journal, July 1976 Mimeo
- C. "Surviving a Real Estate Crisis," Peter C.M.S. Braun, Business Horizons, April 1975 Mimeo

Wed. May 4

CASE PROBLEM DUE IN CLASS (LATE PAPERS PENALIZED 20%)

Mon. May 9

OTHER TAX SHELTER DEALS - OIL, CATTLE & MOVIES

- A. "What Do Airplanes, Railroads Cars, Beef Cattle, Motion Pictures, Real Estate and Oil Wells All Have in Common?" William D. Dyke, Wisconsin Bar Bulletin, June 1975 Mimeo

CONT'D.

- B. "An Annuity For All Seasons," Forbes, May 1, 1976 Mimeo
- C. "Oil and Gas," Tax Sheltered Investments, pp. 292-393, edited by publishers of Real Estate Syndication Digest, 1973 Mimeo
- D. "Cattle," Tax Sheltered Investments, pp. 396-448, edited by publishers of Real Estate Syndication Digest, 1973 Mimeo

Wed. May 11

CASE PRESENTATION - CLASSROOM REVIEW AND DISCUSSION

Wed. May 18

TWO-HOUR WRITTEN EXAM

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Second Edition

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San Francisco (17.50)

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	D. "Financial Analysis of Real Property Investments," Harvard Business School	Mimeo
	E. "Using the Discounted Yield to Compare Real Estate Alternatives," Robert Ellis, Coldwell Banker	Handout
	F. "Leverage in Real Estate," Stanford University, Graduate School of Business	Mimeo
	G. <u>Modern Real Estate Investment</u> , p. 1 - 44 (Scan)	Text
Wed. Jan. 26	EVOLUTION OF INCOME PROPERTY YIELD ANALYSIS	
	A. "Real Estate Financial Analysis - The State of the Art," Oakleigh J. Thorne, <u>Appraisal Journal</u> , Jan. 1974	Mimeo
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Wed. Feb. 9	EXERCISE #1 - MR. CAP	
Mon. Feb. 14	INTRODUCTION TO EQUITY RISK ANALYSIS	
	A. <u>Modern Real Estate Investment</u> , p. 57 - 97	Text
	B. "Evaluating Risk in Real Estate Investments," Michael Young	Mimeo
	C. "A Framework and Computer Model for Risk Analysis and Risk Management in Real Property Development," Mike Miles	Mimeo
	D. "The Reasons Behind the Real Estate Crash: A Case Study," Howard H. Stevenson, <u>Real Estate Review</u>	Mimeo
Wed. Feb. 16	EXERCISE #2 - MR. CAP	
Mon. Feb. 21	REAL ESTATE AND THE FEDERAL INCOME TAX	
	A. Chapter XI, "Sale or Exchange of Property," Section 903-935, <u>U.S. Master Tax Guide 1977</u> , Commerce Clearing House, Chicago	Mimeo
	B. "Changes in Depreciation and Recapture - Impact on Real Estate Investments," Emil Sunley <u>Appraisal Journal</u> , Oct. 1970	Mimeo
	C. "Real Estate and Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act," Ritter & Sunley, <u>Maryland Law Review</u> , Winter 1970	Mimeo
Wed. Feb. 23	REAL ESTATE AND THE FEDERAL INCOME TAX	
	A. Chapter XI, "Sale or Exchange of Property," Section 963-977, 987-988, 999, <u>U.S. Master Tax Guide 1977</u> , Commerce Clearing House, Chicago	Mimeo

cont'd.

- B. "Proposed Tax Reform - Inconsistent With National Housing Policy," Stephen Roulac, The Appraisal Journal, April 1974 Mimeo
- C. "Some Overlooked Aspects of Artificial Accounting Losses, Limited Partnerships & Tax Reduction," Brueggeman & Greenwood Mimeo

Mon. Feb. 28

ESTATE PLANNING & REAL ESTATE INVESTMENT

- A. Chapter XI, "Sale or Exchange of Property," Section 944, 960, U.S. Master Tax Guide 1977 Commerce Clearing House, Chicago Mimeo
- B. "Introductory Orientation on the Estate Planning Art," Casey, Institute for Business Planning Mimeo
- C. Section 1: Inheritance and Estate Tax - Wis. CLEW Mimeo
- D. Kersten V. Wis. Department of Revenue - March 1976 Mimeo
- E. "Andorra is the Ultimate in Tax Shelters" Mimeo

Wed. Mar. 1

ESTATE PLANNING CONT'D.

- A. "Choosing Appropriate Estate Planning Tools: A Goal Oriented Matrix Approach," John R. Graham CLU Journal Mimeo
- B. "Estate Planning for Farmers & Ranchers," Donald H. Kelley, The Practical Lawyer, Feb. 1974 Mimeo

Mon. & Wed.
Mar. 7 & 9

Replaced by all day session, Saturday, March 12 - Lowell Hall - EDUCARE terminals

Mon. Mar. 14

LIMITED PARTNERSHIPS

- A. Real Estate Securities and Syndication Workbook Stephen Roulac, Chapters 1-14, Scan 4, 5, 7, 13 Roulac Text
- B. "How to Form the Perfect Syndicate," Real Estate Mortgage Newsletter Mimeo
- C. "Case Study of a Private Real Estate Syndication" Mimeo
- D. "Partners & Partnerships" Chap. 3, U.S. Master Tax Guide 1977, Commerce Clearing House, Chicago Mimeo

Wed. Mar. 16

LIMITED PARTNERSHIPS

- A. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems," Stephen Roulac, Real Property, Probate and Trust Journal, Summer 1975 Mimeo

cont'd.

	B. "Proposed Statement of Policy for Intra-State Partnerships," State of Michigan	Mimeo
	C. Appendix B, McNeil Pacific Investors Fund Prospectus	Roulac Syndication Text
Mon. Mar. 21	JOINT VENTURES	
	A. "Real Estate Equity Investments," and "The Institutional Lender; Nothing Ventured Nothing Gained," F. E. Rogge, G. J. Talbot, R. M. Zinman, <u>Fordham Law Review</u> , Vol. 39, May 1971	Mimeo
	B. "Introduction to Taxation and Other Legal Problems of Unincorporated Real Estate Entities," Martin B. Cowan, <u>Joint Ventures in Real Estate - 2D</u> , Practising Law Institute	Mimeo
	C. "How to Account for Real Estate Joint Ventures," James J. Klink, <u>Real Estate Review</u> , Spring 1974	Mimeo
Wed. Mar. 23	JOINT VENTURES CONT'D.	
Mon. Mar. 28	EXERCISE #3 - MR. CAP	
Wed. Mar. 30	TWO-HOUR MID-SEMESTER EXAM	
Mon. Apr. 11	REAL ESTATE AS A SECURITY	
	A. <u>Modern Real Estate Investment</u> , P. 99-161, p. 263-278	Text
	B. "SEC Disclosure Practices in Tax Sheltered Offerings," Barry Thorpe, <u>Real Estate Law Journal</u> , Special Supplement	Mimeo
Wed. Apr. 13	REAL ESTATE INVESTMENT TRUSTS	
	A. "NAREIF Handbook of Member Trusts," National Association of Real Estate Investment Funds, 1970	Mimeo
	B. "Conflict of Interest Problems in the Management of REIT's, Douglas W. Duval, <u>Real Estate Law Journal</u> , Summer 1974	Mimeo
	C. "Tax Problems of Mortgage Investment Trusts," Robert B. Klein	Mimeo
	D. "Lessons From the Mortgage Trust Experience," Howard H. Stevenson, <u>Real Estate Review</u> , Fall 1976	Mimeo

Mon. Apr. 18

CONDOMINIUMS AS A REAL ESTATE INVESTMENT

- A. Pages 12-43, Commercial & Industrial Condominiums, John C. Melaniphy, Jr., a special report by the Urban Land Institute, 1976 Mimeo
- B. "Condominiums As Securities: A Current Look," David Clurman, New York Law Forum, Vol. 19, 1974 Mimeo
- C. "Condominium Regulation: Beyond Disclosure," University of Pennsylvania Law Review, Vol. 123:639, 1975 Mimeo

Wed. Apr. 20

LAND AND FARM INVESTMENTS

- A. "Preliminary Remarks: Farmland," unpublished material by James Ablan & James Graaskamp, April 1976 Mimeo
- B. Federal Taxes Affecting Real Estate, Chap. 10 Mimeo
- C. Federal Taxes Affecting Real Estate, Chap. 14, Sections 14.05, 14.08, 14.09 Mimeo
- D. Chapter XI, "Sale or Exchange of Property," Section 998 & 998E, 978, U.S. Master Tax Guide 1977, Commerce Clearing House, Chicago Mimeo

Mon. Apr. 25

TAX-DEFERRED EXCHANGES OF REAL ESTATE

- A. "Comments on Tax-Deferred Exchanges of Real Estate," Henry J. Olivieri, Jr. & Robert H. Johnson, Real Estate Investment Analysis, by James R. Cooper, Chap. 9, D.C. Heath and Co. Lexington, Mass. 1974 Mimeo
- B. Federal Taxes Affecting Real Estate, Chaps. 7 & 8 Text

Wed. Apr. 27

REAL ESTATE INVESTMENT STRATEGY

- A. "Can Real Estate Returns Outperform Common Stocks?" Stephen Roulac, The Journal of Portfolio Management, Winter 1976 Mimeo
- B. "Commitment Planning: An Approach to Reducing Real Estate Risks," by Mahlon Apgar, IV, The Appraisal Journal, July 1976 Mimeo
- C. "Surviving a Real Estate Crisis," Peter C.M.S. Braun, Business Horizons, April 1975 Mimeo
- D. "Ten Green Bottles," Norman Macrae, The Economist Dec. 25, 1976 Mimeo

- Mon. May 2 INSTITUTIONAL INVESTMENT STRATEGY
- A. Modern Real Estate Investment, p. 145-196, Text
p. 307-311, p. 365-462
- Wed. May 4 PROFESSIONAL ASSET MANAGEMENT
- A. Modern Real Estate Investment, p. 467-553 and Text
Appendix 597-640
- B. CASE PROBLEM DUE IN CLASS (LATE PAPERS PENALIZED 20%)
- Mon. May 9 OTHER TAX SHELTER DEALS - OIL, CATTLE & MOVIES
- A. "What Do Airplanes, Railroads Cars, Beef Cattle, Mimeo
Motion Pictures, Real Estate and Oil Wells All
Have in Common?" William D. Dyke, Wisconsin
Bar Bulletin, June 1975
- B. "An Annuity For All Seasons," Forbes, May 1, Mimeo
1976
- C. "Oil and Gas," Tax Sheltered Investments, Mimeo
pp. 292-393, edited by publishers of Real Estate
Syndication Digest, 1973
- D. "Cattle," Tax Sheltered Investments, pp. 396-448, Mimeo
edited by publishers of Real Estate Syndication
Digest, 1973
- Wed. May 11 CASE PRESENTATION - CLASSROOM REVIEW AND DISCUSSION
- Wed. May 18 TWO-HOUR WRITTEN EXAM

Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1978

Prof. James A. Graaskamp

I. Objectives

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

II. General Course Format

Each week will have selected readings which are required. There will be a lecture on Mondays which, hopefully, will shed some light and organization on the readings selected. On Wednesdays, there will be a lecture or a lab session devoted to problem technique. There will be a two-hour exam at mid-semester and another at the end of the semester on these readings, and these exams will be 60% of your grade.

There will be a series of problem exercises which will represent 40% of your grade.

III. Textbooks

Recommended for purchase:

Modern Real Estate Investment, Stephen Roulac, Property Press,
San Francisco (\$17.50)

Real Estate Investment Analysis, Robert M. Ellis, Coldwell Banker
Company, 1976 (\$11.00)

Mimeograph Package - \$15.00

Books and mimeos can be purchased for cash from the University of Wisconsin Real Estate Club in Room 118 at the prices indicated. No credit.

NOTE: ALL PAPERS AND EXERCISES TO BE HANDED IN SHOULD BE STAPLED AT UPPER LEFT HAND CORNER AND GIVEN A TITLE PAGE BUT LEFT WITHOUT PLASTIC BINDERS OR OTHER SIMILAR COVERS.

Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1978

Prof. James A. Graaskamp

Mon. Jan. 23	Introduction - Defining the Context of Real Estate Equity
Wed. Jan 25	Intensive Review of Coldwell Banker
Mon. Jan. 30	Introduction to PDP 1170 - BFCF, Mini-Mod, MR CAP
Wed. Feb. 1	Investment Theory & Real Estate Analysis (Case Exercise #1)
Feb. 6 & 8	" " " " "
Feb. 13 & 15	Real Estate and the Federal Income Tax
Mon. Feb. 20	Tax Deferred Exchanges of Real Estate
Feb. 22 & 27	Real Estate and Estate Planning
Mar. 1 & 6	Limited Partnership
Mar. 8 & 13	Real Estate as a Security
Wed. Mar. 15	TWO HOUR MID-SEMESTER EXAM
SPRING VACATION	
Mar. 29 - Apr. 3	Joint Ventures
Wed. Apr. 5	Case Exercise #2
Apr. 10, 12 & 17	Real Estate Investment Trusts
Wed. Apr. 19	Real Estate Investment Pools & Pension Funds
Mon. Apr. 24	Case Exercise #3
Apr. 26 & May 1	Land and Farm Investments
Wed. May 3	Condominiums as a Real Estate Investment
Mon. May 8	Other Tax Shelter Deals - Oil, Cattle, and Movies
May 10 & 15	Open for Unfinished Material
Wed. May 17	FINAL EXAM

Business 850 - Spring 1978

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Mon. Jan. 23	THE INTRODUCTION-DEFINING CONTEXT OF REAL ESTATE EQUITY	
	A. "Dr. Pond and the State of the Literature in Real Estate Analysis and Valuation," Michael Hanrahan, Dec. 1975	Mimeo
	B. "A Rational Approach to Feasibility Analysis," James A. Graaskamp, Chap. 3	Mimeo
	C. MODERN REAL ESTATE INVESTMENT, pp. 1-44, 297-305	Text
Wed. Jan. 25	INTENSIVE REVIEW OF COLDWELL BANKER	
Mon. Jan. 30	COMPUTER TERMINAL LAB - Room 103	
	A. Sample PDP 1170 runs, BFCF, Mini-Mod, MR CAP, Ellwood	Mimeo
Wed. Feb. 1	EVOLUTION OF INCOME PROPERTY YIELD ANALYSIS	
	A. "Real Estate Financial Analysis - The State of the Art," Oakleigh J. Thorne, <u>Appraisal Journal</u> , Jan. 1974	Mimeo
	B. "How Should Yield be Measured in Real Estate Investment," James R. Cooper, Part 1 & Chap. 1	Mimeo
	C. "How to Assess Investment Proposals," Robert H. Baldwin, <u>Harvard Business Review</u> , May-June 1957	Mimeo
	D. "Differences Between the Major Discounted Cash Flow Capital Budgeting Techniques," Chap. 3, pp. 45-63, Eugene Brigham, <u>Readings in Managerial Finance</u>	Mimeo
	E. "Real Estate Investment Analysis: IRR Versus FMRR," Steven Messner & M. C. Findlay III, <u>Real Estate Appraiser</u> , July-Aug. 1975	Mimeo
	F. MODERN REAL ESTATE INVESTMENT , pp. 353-364	Text
Mon. Feb. 6	INVESTMENT THEORY & REAL ESTATE ANALYSIS	
	A. "Reprogramming the Money Manager," Chris Welles <u>Institutional Investor</u> Apr. 77	Mimeo
	B. "Contemporary Decision Theory & Real Estate Investment," R.U. Ratcliff & Bernie Schwab	Mimeo
	C. MODERN REAL ESTATE INVESTMENT, pp. 57-73, 81-97, 227-242	Text

Business 850 - Spring 1978

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Wed. Feb. 8	INVESTMENT THEORY & REAL ESTATE ANALYSIS	
	A. "Evaluating Risk & Real Estate Investments," Michael Young	Mimeo
	B. "A Computer Simulation Model to Measure the Risk in Real Estate Investment," Steven Phyrre, Chap. 13	Mimeo
	C. "The Analysis of Real Estate Investments Under Uncertainty," Peter K. Pellatt	Mimeo
Mon. Feb. 13	STRATEGIES FOR INVOLVEMENT IN REAL ESTATE	
	A. MODERN REAL ESTATE INVESTMENT, pp. 169-196 Scan - pp. 201-226, emphasize - pp. 263-296	Text
	B. Introduction to <u>1978 U.S. Master Tax Guide</u> , CCH Briefly review checklists 51-68 Individuals and corporations, Sections 100 and 200 Concentrate on "Sale or Exchange of Property" 901, pp. 310-317, pp. 324-332, 334-346, pp. 350-358	Text
Wed. Feb. 15	A. <u>1978 Master Tax Guide</u> , complete Section 901 and concentrate on depreciation, Section 1151, pp. 417-453	Text
	B. MODERN REAL ESTATE INVESTMENT, pp. 243-262, 307-316	Text
	C. "How the New Tax Law Alters Cash Flow: A Case Study," William Brueggeman & Jeffrey Fisher	Mimeo
Mon. Feb. 20	TAX-DEFERRED EXCHANGES IN REAL ESTATE	
	A. "Comments on Tax-Deferred Exchanges of Real Estate," Henry J. Olivieri, Jr. & Robert H. Johnson, <u>Real Estate Investment Analysis</u> , by James R. Cooper, Chap. 9, D.C. Heath and Co. Lexington, Mass. 1974	Mimeo
	B. "Computerized Exchange Evaluation Model," Butler/Henderson, <u>The Appraisal Journal</u> July 1977, pp. 383 - 395	Mimeo
Wed. Feb. 22	DISCUSSION OF CASE EXERCISE #1	
	A. "Neighborhood Revitalization and the Historic Preservation Incentive of the Tax Reform Act of 1976: Lessons from the Bottom Line of a Chicago Red Brick Three Flat," Richard J. Roddewig and Michael Young	Mimeo

Business 850 - Spring 1978

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Wed. Feb. 22	Continued B. "Historic Preservation and the 1976 TRA" <u>Urban Trends</u> , January 1978	Mimeo
Mon. Feb. 27	REAL ESTATE AND ESTATE PLANNING A. "Federal Estate and Gift Taxes" <u>Taxes 1978</u> , Wisconsin Taxpayers Alliance, pp. 20-29 B. Review Chap. IX, "Sale or Exchange of Property, Sections 942-960. C. "Introductory Orientation on the Estate Planning Art," Casey, Institute for Business Planning D. Kersten V. Wis. Department of Revenue - March 1976 E. "Andorra is the Ultimate in Tax Shelters"	Text Mimeo Mimeo Mimeo
Wed. Mar. 1	ESTATE PLANNING CONT'D A. "Choosing Appropriate Estate Planning Tools: A Goal Oriented Matrix Approach," John R. Graham, <u>CLU Journal</u> B. "Estate Planning for Farmers & Ranchers," Donald H. Kelley, <u>The Practical Lawyer</u> , Feb. 1974	Mimeo Mimeo
Mon. Mar. 6	LIMITED PARTNERSHIPS A. Chap. 8, 9, & 10, PRINCIPLES OF REAL ESTATE SYNDICATION, Samuel K. Freshman, pp. 139-186 B. <u>1978 Master Tax Guide</u> , "Partners and Partner- ships," p. 127-150	Mimeo Text
Wed. Mar. 8	LIMITED PARTNERSHIPS CONT'D A. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems," Stephen Roulac, <u>Real Property, Probate and Trust Journal</u> , Summer 1975 B. "Case Study of a Private Real Estate Syndication"	Mimeo Mimeo

Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1979

Prof. James A. Graaskamp

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There will be a series of case problems which will represent 40% of your grade.

III. Textbooks

Recommended for purchase:

Modern Real Estate Investment, Stephen Roulac, Property Press, 1976,
San Francisco (~~\$17.50~~) ~~NOT IN USE~~ \$19.21

Real Estate Investment Analysis, Robert M. Ellis, Coldwell Banker
Company, 1976 (\$11.00) HAVE

Tax Planning for Real Estate Transactions, Coopers and Lybrand, Farm
and Land Broker's Institute, Chicago, 1978 ()

Mimeograph Package - \$15.00

Books and mimeos can be purchased for cash from the University of Wisconsin Real Estate Club in Room 118 at the prices indicated. No credit.

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Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1979

Prof. James A Graaskamp

Mon. Jan. 22	Resources, Society and Capital
Wed. Jan. 25	Property, People, and the Real Estate Package
Mon. Jan. 29	Evolution of Income Property Yield Analysis
Wed. Jan. 31	Current State of the Art
Mon. Feb. 5	Investment Theory and Real Estate Risk
Wed. Feb. 7	Review of MR CAP for Investment Analysis
Mon. Feb. 12	Review of Federal Income Tax Principles
Wed. Feb. 14	Review of Federal Income Tax Definitions
Mon. Feb. 19	Tax Deferred Exchanges in Real Estate
Wed. Feb. 21	Real Estate and Estate Planning
Mon. Feb. 26	Real Estate and Estate Taxes
Wed. Feb. 28	SIX WEEKS EXAM
Mon. Mar. 5	Collective or Group Investment Formats
Wed. Mar. 7	Limited Partnership
Mon. Mar. 12	Limited Partnership (Continued)
Wed. Mar. 14	Case Study No. 2
Mar. 26-Mar. 28	Joint Venture and General Partnership Format
Mon. Apr. 2	Real Estate Investment Trusts
Wed. Apr. 4	Public Real Estate Corporate Stock
Apr. 9-Apr. 11	Commingled Funds and Pension Funds
Mon. Apr. 16	Case Study Problem No. 3
Wed. Apr. 18	TWELVE WEEKS EXAM
Apr. 23-Apr. 25	Farmland and Development Land
Apr. 30-May 2	Commercial Property Investment
May 7-May 9	Hotels and Restaurants
Mon. May 14	Discussion of Case No. 4
Mon. May 16	FINAL EXAM

Business 850 - Spring 1979

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Mon. Jan. 22	RESOURCES, SOCIETY AND CAPITAL	
	A. "Will Capitalism Survive?" Benjamin A. Rogge, <u>MGIC Newsletter</u> , October, 1978	Mimeo
	B. "When the World Runds Out of Oil," Steve Sherman, <u>Yankee Magazine</u> , February, 1977	Mimeo
	C. "The Coming Entrepreneurial Revolution: A Survey," <u>The Economist</u> , December 25, 1976	Mimeo
	D. "The Influence of Capital Market Theory on Real Estate Returns and the Value of Economic Analysis" Stephen Roulac, <u>Structuring Real Estate Investments</u>	Mimeo
Wed. Jan. 24	PROPERTY, PEOPLE, AND THE REAL ESTATE PACKAGE	
	A. "The Future of the Real Estate Industry: Changing Supply Patterns," "Tomorrow's Changing Demand for Real Estate," and "The Future of the Real Estate Industry: New Directions and New Roles," John McMahan, <u>Real Estate Review Series</u>	Mimeo
	B. "Inflation and the Real Estate Investor," Wendt, <u>The Appraisal Journal</u> , July 1977	Mimeo
	C. MODERN REAL ESTATE INVESTMENT, p. 1-44, 297-305	Text
Mon. Jan. 29	EVOLUTION OF INCOME PROPERTY YIELD ANALYSIS	
	A. "How to Assess Investment Proposals," Robert H. Baldwin, <u>Harvard Business Review</u> , May-June 1957	Mimeo
	B. "Differences Between the Major Discounted Cash Flow Capital Budgeting Techniques," Chap. 3, p. 45-63, Eugene Brigham, <u>Readings in Managerial Finance</u>	Mimeo
	C. "Real Estate Financial Analysis - The State of the Art," Oakleigh J. Thorne, <u>Appraisal Journal</u> , Jan. 1974	Mimeo
	D. "Real Estate Investment Analysis: IRR Versus FMRR," Steven Messner & M. C. Findlay III, <u>Real Estate Appraiser</u> , July-Aug. 1975	Mimeo
	E. MODERN REAL ESTATE INVESTMENT, p. 57-73, 353-364	Text
Wed. Jan. 31	CURRENT STATE OF THE ART	
	A. REAL ESTATE INVESTMENT ANALYSIS, Chap. 1-5, Chap. 11-13 (Bring Coldwell Banker text to class	Text

BRING
COLDWELL
BANKER!

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<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Mon. Feb. 5	INVESTMENT THEORY AND REAL ESTATE RISK	
	A. MODERN REAL ESTATE INVESTMENT, p. 81-97, 227-242	Text
	B. "Reprogramming the Money Manager," Chris Welles <u>Institutional Investor</u> , Apr. 77	Mimeo
	C. "Contemporary Decision Theory & Real Estate Investment," R. U. Ratcliff & Bernie Schwab	Mimeo
	D. "Commitment Planning: An Approach to Reducing Real Estate Risks," Mahlon Apgar, IV, <u>The Appraisal Journal</u> , July 1976	Mimeo
	E. "Large Scale Real Estate Investments - Under- standing the Risks through Modeling," Stevenson and Jackson, <u>The Appraisal Journal</u> , July 1977	Mimeo
Wed. Feb. 7	(SPECIAL REVIEW LAB ON WITTS AND MR CAP TO BE SCHEDULED FOR THIS WEEK) REVIEW OF MR CAP FOR INVESTMENT ANALYSIS	
	A. MR CAP Manual	
	B. CASE STUDY PROBLEM NO. 1	
Mon. Feb. 12	REVIEW OF FEDERAL INCOME TAX PRINCIPLES	
	A. MODERN REAL ESTATE INVESTMENT, scan pages 169-226; Emphasize pages 243-296	Text
	B. REAL ESTATE INVESTMENT ANALYSIS, p. 27	Text
	C. "Special Report: How the New Tax Law Affects Real Estate and Other Investors," <u>The Mortgage and Real Estate Executives Report</u> , Nov. 15, 1978, p. 3-8	Mimeo
	D. TAX PLANNING FOR REAL ESTATE TRANSACTIONS, Chap. 1-3	Text
Wed. Feb. 14	REVIEW OF FEDERAL INCOME TAX DEFINITIONS	
	A. TAX PLANNING FOR REAL ESTATE TRANSACTIONS, Chap. 4-6	Text
Mon. Feb. 19	TAX DEFERRED EXCHANGES IN REAL ESTATE	
	A. TAX PLANNING FOR REAL ESTATE TRANSACTIONS, Chap. 7, 8, 11	Text
	B. "Computerized Exchange Evaluation Model," Butler/ Henderson, <u>The Appraisal Journal</u> , July 1977, p. 383- 395	Mimeo
	C. Tax-Deferred Exchange - Planning Considerations Valachi	
	D. Master Tax Guide	

E. APPRAISAL BRIEF - LEGISLATION & TRENDS
 F. ANNUITY FOR ALL SEASONS.

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<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Wed. Feb. 21	REAL ESTATE AND ESTATE PLANNING	
	A. "Federal Estate and Gift Taxes," <u>Taxes</u> , 1979 Wisconsin Taxpayers Alliance, p. 20-29	Text
	B. "Introductory Orientation on the Estate Planning Art," Casey, Institute for Business Planning	Mimeo
	C. "Choosing Appropriate Estate Planning Tools: A Goal Oriented Matrix Approach," John R. Graham, <u>CLU Journal</u>	Mimeo
	D. "An Annuity for all Seasons"	Mimeo
Mon. Feb. 26	REAL ESTATE AND ESTATE TAXES	
	A. Review Chap. 1, TAX PLANNING FOR REAL ESTATE TRANSACTIONS	Text
	B. "Special Use" Valuation of Farm, Ranch and Closely Held Business Real Property," Maurice J. O'Sullivan, Jr., <u>Estate and Gift Tax After Reform</u> , p. 95-121 After Art. "A", March 5 ^m -	Mimeo
Wed. Feb. 28	SIX WEEKS EXAM	
Mon. Mar. 5	COLLECTIVE OR GROUP INVESTMENT FORMATS	
	A. Definition of a Security "As Applied to Real Estate" <u>Advanced Techniques in Real Estate Syndication</u> , Stephen Roulac, RESSI, p. 281-329	Mimeo
	A. 12 Mimeo B. <u>Notes on Forms of Real Estate Ownership</u> , p. 1-15	Mimeo
Wed. Mar. 7	LIMITED PARTNERSHIP	
	A. <u>Real Estate Limited Partnership</u> , Lynn, Goldberg, and Abrams, p. 1-60	Mimeo
	B. "Proposed Statement of Policy of the Corporation & Securities Bureau, Michigan Department of Commerce Regarding Limited and Certain Qualified Offerings of Real Estate," Preliminary Draft No. 2, Jan. 14, 1974 - Also	Mimeo
Mon. Mar. 12	LIMITED PARTNERSHIPS (Continued)	
	* A. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems," Stephen Roulac, <u>Real Property, Probate and Trust Journal</u> , Summer 1975	Mimeo

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<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Mon. Mar. 12	LIMITED PARTNERSHIPS (Cont.)	
	B. "Statement of Policy - Midwest Rules Regarding Real Estate Program, p. 376-421 WITH THE MICHIGAN (3/7/79) READING	Mimeo
	C. "Due Diligence Checklist for Broker-Dealers Handling Tax Shelter Securities," Lewis G. Mosberg	Mimeo
Wed. Mar. 14	CASE STUDY PROBLEM NO. 2	
	A. "Analysis of a Limited Partnership Prospectus,"	
	SPRING BREAK	
Mon. Mar. 26-28	JOINT VENTURE AND GENERAL PARTNERSHIP FORMAT	
	A. "Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained," Roegge et. al.	Mimeo
	* B. "General Partnership Agreement Used by Institutional Investor," by Roegge, <u>Joint Ventures in Real Estate</u> , Practising Law Institute, New York, 1971	Mimeo
	C. Be prepared to write a 15-minute quiz critique on Sample Joint Venture Agreement, Appendix 3, p. 542-546, MODERN REAL ESTATE INVESTMENT	Text
Mon. Apr. 2	REAL ESTATE INVESTMENT TRUSTS "How One R.E. Portfolio Fared" - Warner & Aldridge - RE. Review	
	A. "What Went Wrong with the REITs?" Howard H. Stevenson, <u>The Appraisal Journal</u> , April 1977	Mimeo
	B. "Tax Breaks for REITs Under the Tax Reform Act," Englebrecht and Kramer, <u>Real Estate Review</u>	Mimeo
	C. "Conflict of Interest Problems in the Management of REITS," Douglas W. Duval, <u>Real Estate Law Journal</u>	Mimeo
	* D. <u>New Opportunities in Realty Trust</u> , selected items Back to Back	Mimeo
Wed. Apr. 4	PUBLIC REAL ESTATE CORPORATE STOCK	
	A. "The Rise of the Superbuilder," Campbell, <u>Housing</u> , June 1978 Back to Back w/ Reading for May 9th	Mimeo
	B. "Market-Value Accounting: An Interview with Barron Hilton, <u>The Cornell Motel and Restaurant Administration Quarterly</u> , Aug. 1977, Vol. 18, No. 2	Mimeo

Business 850 - Spring 1979

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Mon. Apr. 9-11	COMMINGLED FUNDS AND PENSION FUNDS	
	A. "Institutional Strategies for Real Estate Investment, Roulac and King, <u>The Appraisal Journal</u> , April 1978	Mimeo
	B. "Bank Trust Department Operation of Commingled Real Estate Funds," Miles and Langford, <u>Real Estate Issues</u> , Vol. 3, No. 2, Winter 1978, p. 62-73	Mimeo
	C. p. 307-336, 365-400, Appendix 597-640, MODERN REAL ESTATE INVESTMENT, Roulac	Text
	D. Scan 341-351, 281-296, MODERN REAL ESTATE INVESTMENT Roulac	Text
	* E. "Should Trustees and Other Institutional Investor Purchase Shares in the Market Fund?" Richard Posner, University of Chicago Law School, July 14, 1972	Mimeo
Mon. Apr. 16	CASE STUDY PROBLEM NO. 3	
Wed. Apr. 18	TWELVE WEEK EXAM	
Mon. Apr. 23-25	FARMLAND AND DEVELOPMENT LAND	
	A. "Agricultural Land Investment: Profit Opportunity or New Speculative Bubble?" Stephen E. Roulac, <u>The Appraisal Journal</u> , January 1978	Mimeo
	B. TAX PLANNING FOR REAL ESTATE TRANSACTIONS, Chap. 10	Text
	* C. "Investment Attribute Matrix: Farm vs. Apartment, : unpublished material by James Graaskamp	Mimeo
Apr. 30-May 2	COMMERCIAL PROPERTY INVESTMENT	
	A. TAX PLANNING FOR REAL ESTATE TRANSACTIONS, Chap. 9, 12	Text
	B. p. 427-482, 495-524, MODERN REAL ESTATE INVESTMENT, Roulac	Text
	C. CASE STUDY PROBLEM NO. 4	
May 7 - May 9	HOTELS AND RESTAURANTS	
	A. TAX PLANNING FOR REAL ESTATE TRANSACTIONS, Chap. 13	Text
	B. "The Risk Structure of the Hotel Industry," Arbel and Grier, <u>The Cornell Hotel and Restaurant Administration Quarterly</u> , Nov. 1978, Vol. 19, No. 3	Mimeo

Business 850 - Spring 1979

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
May 7 - May 9	HOTELS AND RESTAURANTS (Cont.)	
	C. "Resort Time-Sharing: Current Regulation...and the Alternatives, Gunnar, <u>The Cornell Hotel and Restaurant Administration Quarterly</u> , Nov. 1978, Vol. 19, No. 3	Mimeo
	D. "The Appraisal of Lodging Facilities," Rushmore Helmsley-Spear, <u>The Cornell Hotel and Restaurant Administration Quarterly</u> , Aug. 1978, Vol. 19, No. 2	Mimeo
	E. "Hidden Investment Tax Credit in Restaurant Construction," <u>The Cornell Hotel and Restaurant Administration Quarterly</u> , May 1978, Vol. 19, No. 1	Mimeo
	<i>Sanitation Training & Certification - A Ntl. Trend - Chs. Sandler.</i>	
	F. "Administering the Hotel Management Contract: An Analysis of Owner and Operator Concerns, Eyster, <u>The Cornell Hotel and Restaurant Administration Quarterly</u> , Aug. 1977, Vol. 18, No. 2	Mimeo
Mon. May 14	DISCUSSION OF CASE NO. 4	
Wed. May 16	FINAL EXAM	

Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1980

Prof. James A. Graaskamp
Michael L. Robbins

I. Objectives

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

II. General Course Format

Each week will have selected readings which are required. There will be a lecture on Wednesdays which, hopefully, will shed some light and organization on the readings selected. There will be two one-hour exams and another two-hour exam at the end of the semester on these readings. These exams will be 60% of your grade.

There will be a series of case problems which will represent 40% of your grade.

III. Recommended for purchase:

The Real Estate Investment Decision, Gaylon E. Greer, Lexington Books, 1979, Lexington, MA (\$16.00).

Real Estate Investment Analysis, Robert M. Ellis, Coldwell Banker Company, 1976 (\$11.00).

1980 U.S. Master Tax Guide, Commerce Clearing House, Inc., 1979, Chicago (\$5.50).

Taxes 1980, Wisconsin Taxpayers Alliance, 1979, Madison (\$.75).

Real Estate Limited Partnerships, Theodore S. Lynn, Harry F. Goldberg and Daniel S. Abrams, John Wiley & Sons, 1977, New York (\$21.00).

Mimeograph Packet - \$12.50

Total = \$66.75

Books and mimeos can be purchased for cash from the University of Wisconsin Real Estate Club in Room 118 at the prices indicated.
No credit.

<u>Class Period</u>	<u>Readings</u>	
Lecture #1 1/23/80	RESOURCES, SOCIETY AND CAPITAL	JAG
	A. "Will Capitalism Survive?", Benjamin A. Rogge, <u>MGIC Newsletter</u> , October, 1978.	
	B. "When the World Runs Out of Oil", Steve Sherman, <u>Yankee Magazine</u> , February, 1977.	
	C. "The Coming Entrepreneurial Revolution: A Survey", <u>The Economist</u> , December 25, 1976.	
	D. "The Influence of Capital Market Theory on Real Estate Returns and the Value of Economic Analysis", Stephen Roulac, <u>Structuring Real Estate Investments</u> .	
	E. "The Future of the Real Estate Industry: Changing Supply Patterns", "Tomorrow's Changing Demand for Real Estate", and "The Future of the Real Estate Industry: New Directions and New Roles", John McMahan, <u>Real Estate Review Series</u> .	
	F. "Inflation and the Real Estate Investor", Wendt, <u>The Appraisal Journal</u> , July, 1977.	
Lecture #2 1/30/80	RATE OF RETURN AND PRICE	JAG/MLR
	A. <u>The Real Estate Investment Decision</u> (Greer), Chapters 1-5, pp. 1-77.	
	B. <u>Real Estate Investment Analysis</u> (Coldwell Banker), Chapters 1-5, pp. 1-44.	
Lecture #3 2/6/80	PURCHASE PRICE AS DEFINED BY RESALE PRICE (What is Greer and Ellis saying?)	MLR
	A. Greer, Chapters 7-9, pp. 101-172.	
	B. Coldwell Banker, Chapters 11-13, pp. 120-132.	
	C. "Risk Analysis in the Real Property Development Process: A Conceptual Framework and a Computer Simulation Model", Mike Miles and Charles H. Wurtzbach, <u>Journal of Business Research</u> , 1977, pp. 1-33.	
Lecture #4 2/13/80	DEFINING AND MEASURING RISK	MLR
	A. Greer, Chapters 10-14, pp. 175-275.	

<u>Class Period</u>	<u>Readings</u>	
Lecture #5 2/20/80	REVIEW OF FEDERAL TAX PRINCIPLES (Depreciation, Recapture and Deductions)	MLR
	A. Greer, Chapter 6, pp. 79-99.	
	B. <u>Taxes 1980</u> (Taxes), pp. 30-61.	
	C. <u>Real Estate Limited Partnerships</u> (Limited), Chapters 5-6, pp. 67-93.	
	D. <u>1980 U.S. Master Tax Guide</u> (Guide), 1. #1151-#1167, pp. 419-428 2. #1178-#1184, pp. 444-451 3. #357 -#359, p. 152 4. #988 -#996, pp. 354-358	
Lecture #6 2/27/80	CAPITAL GAIN OR LOSS	MLR
	A. Guide, 1. #960 -#999, pp. 338-360 2. #467, p. 177 3. #676, p. 235 4. #137 -#139, pp. 68- 69 5. #1114, pp. 405-406 6. #251 -#253, pp. 112-114 7. #167 -#167F, pp. 82- 88	
Lecture #7 3/5/80	DISPOSITIONS AND TAX CONSEQUENCES	MLR
	A. "Marketing Investment Real Estate" (Marketing), Stephen D. Messner, Irving Schreiber and Victor L. Lyon, <u>Dispositions</u> , 1975, Chapter 10, pp. 172-194.	
	B. Guide, #661-#683, pp. 229-237.	
	C. Limited, Chapter 8, pp. 107-132.	
Lecture #8 3/12/80	REAL ESTATE EXCHANGES	MLR
	A. Coldwell Banker, Chapters 12-13, pp. 122-132.	
	B. Guide, 1. #901-#918, pp. 312-324 2. #934-#959, pp. 329-338	
	C. "Computerized Exchange Evaluation Model", Butler/ Henderson, <u>The Appraisal Journal</u> , July, 1977, pp. 383-395.	
3/19/80	SPRING BREAK	

<u>Class Period</u>	<u>Readings</u>	
Lecture #9 3/26/80	OWNERSHIP FORM - GENERAL TYPES	MLR
	A. Greer, Chapter 14, pp. 262-276.	
	B. "Financing Income - Producing Real Estate", James A. Britton, Jr. and Lewis O. Kerwood, <u>Joint Ventures</u> , 1977, Chapter 22, pp. 244-251.	
	C. "Selecting the Form of Entity", <u>Principal of Real Estate Syndication</u> , pp. 139-147.	
Lecture #10 4/2/80	OWNERSHIP FORM - THE LIMITED PARTNERSHIP (What is it and why is it used?)	MLR
	A. Guide, 1. #300-#350, pp. 129-150 2. #381-#389, p. 156	
	B. Limited, 1. Chapters 1-4, pp. 1- 60 2. Chapter 7, pp. 95-103	
Lecture #11 4/9/80	OWNERSHIP FORM - THE LIMITED PARTNERSHIP (How is it regulated?)	MLR
	A. Limited, Chapters 9-12, pp. 133-211.	
	B. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems", Stephen Roulac, <u>Real Property, Probate and Trust Journal</u> , Summer 1975.	
Lecture #12 4/16/80	OWNERSHIP FORM - THE CORPORATION OR TRUST	MLR
	A. Guide, 1. #201-#299, pp. 99-128 2. #401-#497, pp. 157-185	
Lecture #13 4/23/80	ESTATE PLANNING	MLR
	A. "Choosing Appropriate Estate Planning Tools: A Goal-Oriented Matrix Approach", John R. Graham, <u>CLU Journal</u> .	
	B. <u>Estate Planning Book</u> , 1. Chapters 1-4, pp. 1- 63 2. Chapter 15, pp. 227-247 3. Chapter 19, pp. 331-350	
	C. Clifford Case.	

Class PeriodReadings

Lecture #14
4/30/80

REAL ESTATE PORTFOLIO MANAGEMENT

MLR

- A. "Real Estate Investment Preception: A Multidimensional Analysis", Larry E. Wofford and R. Keith Preddy, AREUEA Journal, 1978, pp. 22-36.
- B. "Institutional Strategies for Real Estate Investment", Stephen E. Roulac and Donald A. King, Jr., The Appraisal Journal, 1978, pp. 257-270.
- C. "Modern Portfolio Theory - Reprogramming the Money Manager", Chris Welles, Institutional Investor, April, 1977.
- D. "Real Property Economics for the Tax-Exempt Investor", Stephen E. Roulac, Modern Real Estate Investment, Chapter 17, pp. 307-315.
- E. "Structuring Institutional Investments", Stephen E. Roulac, Modern Real Estate Investment, Chapter 21, pp. 365-384.
- F. Federal Taxes Affecting Real Estate, Robert Sandison, et al, Chapter 16, pp. 433-451.

Lecture #15
5/7/80

FORMAL PRESENTATION OF CASE STUDIES

Incomplete Reading List

Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1981

Prof. James A. Graaskamp

I. Objectives:

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

II. General Course Format:

Each week will have selected readings which are required. There will be a lecture on Mondays which, hopefully, will shed some light and organization on the readings selected. On Wednesdays, there will be a lecture or a lab session devoted to problem technique. There will be a two-hour exam at mid-semester and another at the end of the semester on these readings, and these exams will be 60% of your grade.

There will be a series of problem exercises which will represent 40% of your grade.

III. Textbooks:

Recommended for purchase:

The Real Estate Investment Decision, Gaylon E. Greer, Lexington Books 1979 (Available at book store)

Taxes 1981, Wisconsin Taxpayers Alliance (\$1.00)

1981 United States Master Tax Guide, Commerce Clearing House (\$6.00)

Real Estate Investment Strategy in the 1980's, Robert M. Ellis, Coldwell Banker Company, 1980 (Included in reading packet)

Mimeograph Package - \$15.00

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Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1981

Prof. James A. Graaskamp

Wed.	Jan.	21	INTRODUCTION - EXPLICIT AND IMPLICIT ATTITUDES FOR REAL ESTATE EQUITY INVESTMENT
Fri.	"	23	SPECIAL 2:30 SEMINAR WITH PROF. AUSTIN JAFFE
Mon.	"	26	RANKING THE DECISION CRITERIA FOR EQUITY INVESTMENT OPPORTUNITIES
Wed.	"	28	BASIC CONCEPTS AND INVESTMENT THEORY (CASE #1 FROM FIRST NATIONAL OF CHICAGO)
Mon.	Feb.	2	ALTERNATIVE RATE OF RETURN ANALYSIS (Introduction to RATES, BFCF, MR CAP)
Wed.	"	4	INVESTMENT STRATEGIES AND REAL ESTATE ANALYSIS
Fri.	"	6	SPECIAL 2:30 SEMINAR WITH PROF. MIKE MILES
Mon.	"	9	FINANCIAL RISK AND RATIO ANALYSIS
Wed.	"	11	ANALYSIS OF THE FIRST CASE STUDY (COMPUTER EXERCISE SET DUE)
Mon.-Wed.		16-18	REAL ESTATE AND THE FEDERAL INCOME TAX
Mon.-Wed.		23-25	REAL ESTATE AND THE FEDERAL INCOME TAX
Mon.	Mar.	2	TAX DEFERRED EXCHANGES OF REAL ESTATE (EXCHANGE-LEASEBACK CASE EXERCISE #2 DUE)
Wed.-Mon.		4-9	REAL ESTATE AND ESTATE PLANNING
Wed.	"	11	TWO-HOUR MID-SEMESTER EXAM
SPRING RECESS			
Mon.-Wed.		23-25	LIMITED PARTNERSHIPS
Mon.-Wed.		30-	REAL ESTATE AS A SECURITY
	April	1-6	
Wed.	Apr.	8	JOINT VENTURE FORMATS (CLIFFORD CASE EXERCISE #3 DUE)
Mon.-Wed.		13-15	REAL ESTATE INVESTMENT CORPORATIONS
Mon.	"	20	REAL ESTATE INVESTMENT POOLS AND PENSION FUNDS (Room 206 for cassette of Blake Eagle)
Mon.		27-29	REAL ESTATE INVESTMENT TRUSTS
Mon.	May	4	FARM INVESTMENT
Wed.	"	6	DISCUSSION OF FINAL INVESTMENT CASE (CASE EXERCISE #4 DUE)
Mon.	"	11	FINAL EXAM

Business 850 - Spring 1981

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Wed. Jan. 21	INTRODUCTION - EXPLICIT AND IMPLICIT ATTITUDES FOR REAL ESTATE EQUITY INVESTMENT	
	A. "What's Really Happening in the U.S.," John Naisbitt, Sept. 20, 1979	Mimeo
	B. "Managing Fundamentals," Peter Drucker, <u>The Best of Business</u>	Mimeo
	C. "When the World Runs Out of Oil," Steve Sherman, <u>Yankee Magazine</u> , Feb., 1977	Mimeo
	D. "The Coming Entrepreneurial Revolution: A Survey," <u>The Economist</u> , Dec. 25, 1976	Mimeo
	E. "Will Capitalism Survive?" Benjamin Rogge, <u>The MGIC Newsletter</u> , Oct. 1978	Mimeo
	F. "The Great Transition," Kahn, <u>The Next 100 Years</u> , 1978	Mimeo
Mon. Jan. 26	RANKING THE DECISION CRITERIA FOR EQUITY INVESTMENT OPPORTUNITIES	
	A. "A Guide to Understanding the Supply-Siders," <u>Business Week</u> , Dec. 22, 1980	Mimeo
	B. "The Influence of Capital Market Theory on Real Estate Returns & the Value of Economic Analysis," Stephen E. Roulac	Mimeo
	C. "The Future of the Real Estate Industry: Changing Supply Patterns," "Tomorrow's Changing Demand For Real Estate," and "The Future of the Real Estate Industry: New Directions and New Roles," John McMahan, <u>Real Estate Review Series</u>	Mimeo
	D. "Inflation and the Real Estate Investor," Wendt, <u>The Appraisal Journal</u> , July 1977	Mimeo
Wed. Jan. 28	BASIC CONCEPTS AND INVESTMENT STRATEGIES (Case #1 from First National of Chicago)	
	A. Prepare Continental Bank Case - Miller Development, Inc. for class	
	B. Chapters 1-5, <u>The Real Estate Investment Decision</u>	Text

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- Mon. Feb. 2 ALTERNATIVE RATE OF RETURN ANALYSIS (Intro to RATES, BFCF, MR CAP)
- A. Chapters 7-9, The Real Estate Investment Decision Test
 - B. "Real Estate Financial Analysis - The State of the Art," Oakleigh J. Thorne, Appraisal Journal, Jan. 1974 (Review 551) Mimeo
 - C. "Differences Between the Major Discounted Cash Flow Capital Budgeting Techniques, Chap. 3, p. 45-63, Eugene Brigham, Readings in Managerial Finance, (Review Corporate Finance) Mimeo
 - D. "Real Estate Investment Analysis: IRR Versus FMRR," Steven Messner & M. C. Findlay III, Real Estate Appraiser, July-Aug. 1975 Mimeo
 - E. Review of RATES and BFCF
- Wed., Feb. 4 INVESTMENT STRATEGIES AND REAL ESTATE ANALYSIS
- A. Real Estate Investment Strategy in the 1980's, Robert M. Ellis, Coldwell Banker, 1980 Brochure
 - B. "Peril-point Acquisition Prices," John F. Crowther, Harvard Business Review, Sept.-Oct. 1969 Mimeo
 - C. "Evaluating Risk in Real Estate Investments," Michael S. Young. Mimeo
 - D. "Can Real Estate Returns Outperform Common Stocks?" Stephen E. Roulac, The Journal of Portfolio Management, Winter, 1976 Mimeo
 - E. "Risk Analysis in the Real Property Development Process," Journal of Business Research Dec. 1977 Mimeo
- Mon., Feb. 9 FINANCIAL RISK AND RATIO ANALYSIS
- A. Chapter 10-12, The Real Estate Investment Decision Text
 - B. Relevance to sample MR CAP output Class handout
- Wed. Feb. 11 FINANCIAL RISK ANALYSIS, CONTINUED (COMPUTER EXERCISE SET)
- A. Chapter 13, 14, The Real Estate Investment Decision Text

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- Mon. Feb. 16 REAL ESTATE AND THE FEDERAL INCOME TAX
- A. Chapter 6, The Real Estate Investment Decision Text
 - B. Taxes 1981, Wisconsin Taxpayers, pp. 30-60 Text
 - C. 1981 United States Master Tax Guide, Commerce Clearing House (Chap.) Text
 - D. Chapter 10, "Dispositions" Mimeo
- Wed. Feb. 18 REAL ESTATE AND THE FEDERAL INCOME TAX
- A. Chapter 5-8, Tax Planning for Real Estate Investors Text
 - B. 1981 United States Master Tax Guide, Commerce Clearing House (Chap.) Text
- Mon. Feb. 23 REAL ESTATE AND THE FEDERAL INCOME TAX
- A. Chapter 10, Tax Planning for Real Estate Investors Text
 - B. 1981 United States Master Tax Guide, Commerce Clearing House (Chap.) Text
- Wed. Feb 25 REAL ESTATE AND FEDERAL INCOME TAX ISSUES AND OPTIONS
- A. Involuntary Conversions
 - B. Capitalize or Expense Development Soft Costs
 - C. Landmark and Rehabilitation Priorities
 - 1. "Rehabilitation and the Tax Reform Act," Sarah G. Oldham & H. Ward Jandl, Urban Land, December 1977 Mimeo
 - 2. "Rehabilitation Expenditures for Certified Historic Structures Amortization," Federal Tax Coordinator 2d, 12/13/79 Mimeo
 - 3. "Rehabilitation Expenses for Commercial Buildings and Certified Historic Structures May Qualify," Federal Tax Coordinator 2d, 4/5/79 Mimeo
- Mon. Mar. 2 TAX DEFERRED EXCHANGES OF REAL ESTATE (EXCHANGE LEASE-BACK CASE EXERCISE #2 DUE)
- A. Chapter 9, Tax Planning For Real Estate Investors Mimeo
 - B. "Comments on Tax-Deferred Exchanges of Real Estate," Henry J. Olivieri, Jr., Robert H. Johnson, Real Estate Investment, James Cooper Lexington, 1974 Mimeo

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- Mon. Mar. 2 (Continued) C. "Computerized Exchange Evaluation Model," Jay Q. Butler and Glenn V. Henderson, Jr., The Appraisal Journal, July 1977 Mimeo
- D. Case Exercise #2 Due (Make exchange calculations and decide if it makes sense for each party)
- Wed. Mar. 4 REAL ESTATE AND ESTATE PLANNING
- A. "Choosing Appropriate Estate Planning Tools: A Goal-Oriented Matrix Approach," John R. Graham, CLU Journal Mimeo
- B. Estate Planning Book,
 1. Chapters 1-4, pp. 1-63
 2. Chapter 15, pp. 227-247
 3. Chapter 19, pp. 331-350
- Mon. Mar. 9 ESTATE TAXES
- A. Taxes 1981, Wisconsin Taxpayers Alliance, pp. 20-28 Text
- B. The Clifford Case is due at the beginning of class (No late papers accepted)
- Wed. Mar. 11 TWO-HOUR MID-SEMESTER EXAM
- SPRING RECESS

Business 850
REAL ESTATE EQUITY INVESTMENT

Spring 1983

Prof. James A. Graaskamp

I. Objectives:

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

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There will be a series of problem exercises which will represent 40% of your grade.

III. Textbooks:

Recommended for purchase:

Real Estate Investment--Strategy, Analysis, Decisions, Stephen A. Pyhrr and James R. Cooper; Warren, Gorham and Lamont, 1982.
(Available at the book store).

Taxes 1983 Wisconsin Taxpayers Alliance (\$1.00)

Tax Planning for Real Estate Investors, J. Kau & C. F. Sirmans, Prentice-Hall, 1982.

1983 United States Master Tax Guide, Commerce Clearing House (\$6.00)
Optional

Real Estate Investment Strategy in the 1980's, Robert M. Ellis, Coldwell Banker Company, 1980 (Included in reading packet)

Mimeograph Reading Packet

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BUSINESS 850
REAL ESTATE EQUITY INVESTMENT

Spring 1983

Prof. James A. Graaskamp

Mon. Jan. 24	INTRODUCTION - EXPLICIT AND IMPLICIT ATTITUDES FOR REAL ESTATE EQUITY INVESTMENT
Wed. Jan. 26	RANKING DECISION CRITERIA
Mon. Jan. 31	FUNDAMENTALS OF REAL ESTATE INVESTMENT ANALYSES
Wed. Feb. 2	ANALYZING REAL ESTATE MARKETS UNDER CHANGING CONDITIONS
Mon. Feb. 7	BASIC CONCEPTS OF MRCAP; FINANCIAL RATIO ANALYSIS (HOUSTON OFFICE CASE)
Wed. Feb. 9	INTRO TO CURRENT CONCEPTS OF CASH FLOW MANAGEMENT, IMPUTED EQUITY AND IMPUTED RESALE. CASE PROBLEM #1 DUE.
Mon. Feb. 14	TAXATION AND REAL ESTATE INVESTING
Wed. Feb. 16	BUSINESS ORGANIZATIONS AND TAX CONSIDERATIONS
Mon. Feb. 21	ASSIGN CLIFFORD CASE PART I
Wed. Feb. 23	TAXATION DURING OPERATION PHASE
Mon. Feb. 28	TAXATION AND DISPOSITION
Wed. Mar. 2	TAXATION AND DISPOSITION (CONTINUED)
Mon. Mar. 7	SPECIAL PROBLEMS FOR REAL ESTATE AND THE FEDERAL INCOME TAX
Wed. Mar. 9	REAL ESTATE AND ESTATE TAX PLANNING
Mon. Mar. 14	ESTATE PLANNING CONTINUED
Wed. Mar. 16	REVIEW OF TEXT
Mon. Mar. 21	CLIFFORD CASE PART II DUE (ESTATE PLANNING CONTINUED)
Wed. Mar. 23	MID-SEMESTER TWO-HOUR EXAM

* * * SPRING RECESS * * *

Business 850 - Spring 1983

Prof. James A. Graaskamp

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
Mon. Jan. 24	INTRODUCTION - EXPLICIT AND IMPLICIT ATTITUDES FOR REAL ESTATE EQUITY INVESTMENT	
	A. "What's Really Happening in the U.S.," John Naisbitt, Sept. 20, 1979	Mimeo
	B. "When the World Runs Out of Oil," Steve Sherman, <u>Yankee Magazine</u> , Feb., 1977.	Mimeo
	C. "The Coming Entrepreneurial Revolution: A Survey," <u>The Economist</u> , Dec. 25, 1976	Mimeo
	D. "Five Ways to Go Bust," <u>The Economist</u> , Jan., 1983.	Mimeo
	E. "Will Capitalism Survive?" Benjamin Rogge, <u>The MGIC Newsletter</u> , Oct., 1978.	Mimeo
Wed. Jan. 26	RANKING THE DECISION CRITERIA FOR EQUITY INVESTMENT OPPORTUNITIES	
	A. <u>Real Estate Investment Strategy in the 1980's</u> , Robert M. Ellis, Coldwell Banker, 1980	Mimeo
	B. "The Influence of Capital Market Theory on Real Estate Returns & The Value of Economic Analysis," Stephen E. Roulac	Mimeo
	C. "The Future of the Real Estate Industry: Changing Supply Patterns," "Tomorrow's Changing Demand for Real Estate," and "The Future of the Real Estate Industry: New Directions and New Roles," John McMahan, <u>Real Estate Review Series</u>	Mimeo
	D. "Inflation and the Real Estate Investor," Wendt, <u>The Appraisal Journal</u> , July, 1977.	Mimeo
	E. "The Great Transition," Cahn. "Twelve New Emphasis"	Mimeo
	F. "Factors Shaping Development in the 80's," "Looking Forward: A View of Development in the Years Ahead," Robert Nahas and Harold Jansen <u>URBAN LAND</u> , Dec. 1981.	Mimeo
	G. "Managing Fundamentals," Peter Drucker, <u>The Best of Business</u>	Mimeo

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Mon. Jan. 31	FUNDAMENTALS OF REAL ESTATE INVESTMENT ANALYSES	
	A. Chapters 1-3 Pyhrr/Cooper	Text
Wed. Feb. 2	ANALYZING REAL ESTATE MARKETS UNDER CHANGING CONDITIONS	
	A. Chapters 4-7, Pyhrr/Cooper	Text
Mon. Feb. 7	BASIC CONCEPTS OF MRCAP; FINANCIAL RATIO ANALYSIS (HOUSTON OFFICE CASE)	
	A. The Manske MRCAP Manual	Text
	B. Chapters 10, 11, 12, Pyhrr/Cooper	Text
Wed. Feb. 9	INTRO TO CURRENT CONCEPTS OF CASH FLOW MANAGEMENT, IMPUTED EQUITY AND IMPUTED RESALE	
	A. Case Problem #1 Due	
	B. Chapters 14, 15, 17, Pyhrr/Cooper	Text
	C. "Peril-point Acquisition Prices," John F. Crowther, <u>Harvard Business Review</u> , Sept.- Oct. 1969.	Mimeo
Mon. Feb. 14	TAXATION AND REAL ESTATE INVESTING	
	A. Chapter 13, Pyhrr/Cooper	Text
	B. Chapters 1 and 2--Tax Planning for Real Estate Investors, Second Edition, Kau & Sirmans	Text
Wed. Feb. 16	BUSINESS ORGANIZATIONS AND TAX CONSIDERATIONS	
	A. Chapters 3 and 4, Kau & Sirmans	Text
Mon. Feb. 21	ASSIGN CLIFFORD CASE PART I	
Wed. Feb. 23	TAXATION DURING OPERATION PHASE	
	A. Chapters 5, 6, 7, and 8, 9-Kau & Sirmans	Text
Mon. Feb. 28	TAXATION AND DISPOSITION	
	A. Chapters 10 and 11, Kau & Sirmans	Text
Wed. Mar. 2	TAXATION AND DISPOSITION (CONTINUED)	
	A. Chapters 12 and 13, Kau & Sirmans	Text

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- Mon. Mar. 7 SPECIAL PROBLEMS FOR REAL ESTATE AND THE
FEDERAL INCOME TAX
- A. Land Development--1983 U.S. MASTER TAX GUIDE,
Commerce Clearing House. () Text
 - B. Certified Historic Structures--1983 U.S. MASTER
TAX GUIDE, Commerce Clearing House. () Text
 - C. Leasebacks--1983 U.S. MASTER TAX GUIDE,
Commerce Clearing House. () Text
 - D. Wisconsin Tax Guide, 1983, pp. 63-81, 83-92 Text
- Wed. Mar. 9 REAL ESTATE AND ESTATE PLANNING
- A. "Choosing Appropriate Estate Planning Tools:
A Goal-Oriented Matrix Approach," John R.
Graham, CLU Journal Mimeo
 - B. Taxes 1983 Wisconsin, pp. 20-28 Text
 - C. Estate Planning Book,
 - 1. Chapters 1-4, pp. 1-63
 - 2. Chapter 15, pp. 227-247
 - 3. Chapter 19, pp. 331-350
- Mon. Mar. 14 ESTATE PLANNING (CONTINUED)
- Wed. Mar. 16 REVIEW OF TEXT
- A. Chapters 18-23, Pyhrr/Cooper Text
- Mon. Mar. 21 ESTATE PLANNING (CONTINUED)
- A. The Clifford Cast Part II is due at the
beginning of class (No late papers accepted)
- Wed. Mar. 23 MID-SEMESTER TWO-HOUR EXAM

* * * SPRING RECESS * * *

Business 850 - Spring 1983

Mon., Apr. 4 GROUP INVESTMENT FORMATS AND SELECTION CRITERIA

- A. "Charting The Future of Real Estate Prices" Lex., P.A. Mimeo
- B. "Modern Investment Theory and Real Estate Analysis," Peter E. Penny, The Appraisal Journal, January 1982, pp. 70-99 Mimeo
- C. Chapter 14, "Forms of Real Estate Ownership," Real Estate Investment and Taxation, pp. 307-318, Roger Allen Mimeo
- D. "Investment Success Through Ratio Preference Analysis," Victor Trapasso, Real Estate Review, Winter 1983 Mimeo
- E. "Developers Must Control Finance," Questor Real Estate Letter, February 1983 Mimeo

Wed., Apr. 6 CORPORATE FORMATS

- A. "Why Set Up a Corporation to Own Real Estate," McGrady & Weaver, Real Estate Review, Fall '80 Mimeo
- B. Sub Chapter S - Real Estate Tax Ideas, Dec., Jan., & Feb. Mimeo
- C.

Mon., Apr. 11 LIMITED PARTNERSHIPS - EXCHANGE PROBLEM DUE

&

Wed., Apr. 13

- A. Chap. 1, "The State Laws Governing Realty Limited Partnerships," Limited Partnerships, pp. 1-31 Mimeo
- B. "Introduction to Taxation and Other Legal Problems of Unincorporated Real Estate Entities," Martin B. Cowan, The Practicing Law Institute, pp. 419-501 Mimeo
- C. Chap. 9, "Tax Considerations," Chap. 10, "Formation of the Partnership," Freshman, Principles of Real Estate Syndication, pp 149-185 Mimeo
- D. "Structure of Public Real Estate Offerings," Winter, 1982; "Where's the Money Coming From?" Summer 1981; "Sharing of Partnership Liabilities for Tax Purposes," Fall 1981, Stephen Jarchow, Real Estate Review Mimeo
- E. Master Tax Guide, Commerce Clearing House, Partners & Partnership Tax Law, Sections 300-350, 385, 387, 389, 383, 1107, 975, 167B, 1410A Library or Text

Business 850 - Spring 1983

- Wed., Apr. 13 F. "Resolution of Limited Partnership Disputes: Practical and Procedural Problems," Roulac, pp. 105-137 Mimeo
- G. "Creative Disposition Strategies for Limited Partnerships," Nouskajian, Questor Real Estate Investment Yearbook 1982 Mimeo
- H. "CEO's of Big Six Syndicators Expect Major Challenges, Offer Industry Predictions at Historic Meeting," Questor Real Estate Letter December 1982 Mimeo
- Mon., Apr. 18 LIMITED PARTNERSHIP PROSPECTUS PROBLEM
- A. Chapter 16, "A Real Estate Syndication: An Office Building Investment," Part V - THE INVESTMENT PROCESS: CASE EXAMPLES, Real Estate & The Income Tax, Sirmans & Kau Mimeo
- B. Write up analysis of prospectus handed out in class
- Wed., Apr. 20 REAL ESTATE AS A SECURITY
- A. "Regulating Real Estate Investment Activity "New Accountability Standards and Fiduciary Responsibilities," and "The New Pension Legislation," Stephen E. Roulac, Modern Real Estate Investment, pp. 99-168 Mimeo
- B. Statement of Policy by Midwest Securities Commissioners Association, Federal Registration Statement Under the Securities of Act of 1933 Mimeo
- C. Guide 5 Mimeo
- D. "Impacts of Recent Securities Regulatory Development on Real Estate Syndication," Alspach & Derenthal, Questor R.E. Investment Yearbook '82 Mimeo
- E. "Due Diligence of Real Estate Syndications," Hudgens, Questor R.E. Investment Yearbook 1982 Mimeo
- Mon., Apr. 25 JOINT VENTURE FORMATS
- A. "Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained," Roegge, et al Mimeo
- B. "General Partnership Agreement Used by Institutional Investor," Roegge, Joint Ventures in Real Estate, Practising Law Institute, New York, 1971 Mimeo
- C. "Structuring a Joint Venture With a Foreign Investor, Klepper & Moyer, Real Estate Review, Summer 1982 Mimeo

Business 850 - Spring 1983

Wed., Apr. 27 ALTERNATIVE INVESTMENT FORMATS

- A. "An Institutional Explanation of Poor REIT Performance," by Wurtzebach, The Appraisal Journal, January 1977 Mimeo
- B. "New Opportunities in Realty Trusts," by Campbell, Part I Mimeo
- C. "Why REIT Stocks are Undervalued," Marvin Maes, Real Estate Review, Fall 1982 Mimeo
- D. "Creating Value in Real Estate," Shidler Organization, Real Estate Forum, July 1982 Mimeo
- E. "Intriguing Twists in Real Estate," John Curran, Fortune, March, 1983 Mimeo
- F. "REIT Industry Seeing New Interest As It Positions Itself For the Future," Handout
- G. "Pursuing the Foreign Investor," Real Estate Review, Analysis of a Foreign Real Estate Venture, U.S. Citizens Mimeo
- H. "Residential Real Estate Versus Financial Assets," T.J. Coyne, Waldemar, Goulet, Picconi, pp. 20-24 Handout
- I. "Tax Information Planning Series," Price Waterhouse, pp. 1-29, Foreign Investment Mimeo
- J. "Four New Rules For Realty Trust Investors," Chapter 1, pp. 1-23 Handout

Mon., May 2 REAL ESTATE INVESTMENT FOR PENSION FUNDS

- A. "Institutional Strategies for Real Estate Investment," Roulac and King, The Appraisal Journal, April 1978 Mimeo
- B. "Bank Trust Department Operation of Commingled Real Estate Funds," Miles and Langford, Real Estate Issues, Vol. 3, No. 2, Winter 1978, pp. 61-73 Mimeo
- C. Pages 307-336, 365-400, Appendix 597-640, Modern Real Estate Investment, Roulac Mimeo
- D. "Should Trustees and Other Institutional Investor Purchase Shares in the Market Fund?" Richard Posner, University of Chicago Law, July 14, 1972 Mimeo
- E. "Wall Street Enters the Pension Fray," Linda Sandler, Institutional Investor November 1982 Mimeo

Business 850 Spring 1983

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|--------------------------|---|---------|
| Mon., May 2
Continued | F. "Institutional Strategies for Real Estate Equity Investment," John McMahan, pp. 1-19 | Handout |
| Wed., May 4 | REAL ESTATE INVESTMENT FOR PENSION FUNDS (Continued) | |
| | A. "Performance Evaluation of Commingled Funds," Mike Miles | Mimeo |
| | B. "An Annuity for All Seasons," <u>Forbes Magazine</u> , May 1, 1976 | Mimeo |
| | C. "Financing Real Estate Investments of Pension Funds," Garrigan, Sullivan & Young, <u>Real Estate Review</u> , Winter 1981 | Mimeo |
| | D. Real Estate Securities Newsletter, Feb. 1981 | Mimeo |
| | E. "The High Risks of Open-End Real Estate Funds," Rosenberg & Sack, <u>The Journal of Portfolio Management</u> , pp. 55-57 | Mimeo |
| Mon., May 9 | LAND RESOURCES, FARM AND OIL INVESTMENT SHELTERS | |
| | A. "Agricultural Land Investment: Profit Opportunity of New Speculative Bubble?" Stephen E. Roulac, <u>The Appraisal Journal</u> , January 1978 | Mimeo |
| | B. "Estate Tax Special Valuation of Farm and Business Real Estate," by Wiegratz, <u>Wisconsin Bar Bulletin</u> , June 1980 | Mimeo |
| | C. <u>Tax Planning for Real Estate Transactions</u> , Chap. 10 | Text |
| | D. "Building Net Worth With Tax Shelters," Robert Stanger, <u>Tax Shelters</u> , 1982 | Mimeo |
| | E. Kirkpatrick, Campbell & Eaton - Strategy and Real Estate Outlook, | Handout |
| Wed., May 11 | FINAL EXAM | |

BUSINESS 850
REAL ESTATE EQUITY INVESTMENT

Spring, 1985

Prof. James A. Graaskamp

I. Objectives:

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

II. General Course Format:

Each week will have selected readings which are required. There will be a lecture on Mondays which, hopefully, will shed some light and organization on the readings selected. On Wednesdays, there will be a lecture or a lab session devoted to problem technique. There will be a two-hour exam at mid-semester and another at the end of the semester on these readings, and these exams will be 60% of your grade.

There will be a series of problem exercises which will represent 40% of your grade.

III. Textbooks:

Recommended for purchase:

Real Estate Investment--Strategy, Analysis, Decisions, Stephen A. Pvhrr and James R. Cooper; Warren, Gorham and Lamont, 1982.
(Available at the University Bookstore).

Taxes 1985, Wisconsin Taxpayers Alliance.

Real Estate Investment Strategy in the 1980's, Robert M. Ellis, Coldwell Banker Company, 1980. (Included in reading packet).

Mimeograph Reading Packet available at Bob's Copy Shop in Randall Towers.

NOTE: ALL PAPERS AND EXERCISES TO BE HANDED IN SHOULD BE STAPLED AT UPPER LEFT HAND CORNER AND GIVEN A TITLE PAGE BUT LEFT WITHOUT PLASTIC BINDERS OR OTHER SIMILAR COVERS.

REAL ESTATE EQUITY INVESTMENTS

Bus 850
Spring Semester 1985

Prof. James A. Graaskamp

Class Period Readings

M, Jan. 21	INTRODUCTION--POSITIONING FOR THE FUTURE
W, Jan. 23	HISTORICAL DEVELOPMENT OF REAL ESTATE INVESTMENT METHODS
M, Jan. 28	FUNDAMENTALS OF REAL ESTATE INVESTMENT ANALYSIS: MONOPOLY AND SPREAD
W, Jan. 30	BASIC CASH FLOW CONCEPTS AND MRCAP (Assign Case #1)
M, Feb. 4	CHOICE OF REAL ESTATE OWNERSHIP
W, Feb. 6	TAX PLANNING ON ACQUISITION
M, Feb. 11	TAX PLANNING FOR DISPOSITION (Case #1 Due)
W, Feb. 13	TAX PLANNING FOR DISPOSITION (CONTINUED) (Assign Case #2--Clifford Part 1)
M, Feb. 18	SPECIAL PROBLEMS AND TAX CONSTRAINTS ON REAL ESTATE INVESTMENTS
W, Feb. 20	SPECIAL PROBLEMS AND TAX CONSTRAINTS ON REAL ESTATE INVESTMENT (CONTINUED)
M, Feb. 25	ESTATE PLANNING AND TAXES
W, Feb. 27	(CASE #2 DUE: Clifford Part 2--Assigned)
M, Mar. 4	ALTERNATIVE FEDERAL TAX PROPOSALS AND REAL ESTATE
W, Mar. 6	EXCHANGES
M, Mar. 11	REVIEW--CLIFFORD CASE PART 2 DUE
W, Mar. 13	MID SEMESTER EXAM
	SPRING RECESS
M, Mar. 25	JOINT VENTURES
W, Mar. 27	JOINT VENTURES
M, Apr. 1	CORPORATE REAL ESTATE OWNERSHIP
W, Apr. 3	LIMITED PARTNERSHIPS

M, Apr. 8 LIMITED PARTNERSHIPS (CONTINUED)
M, Apr. 10 LIMITED PARTNERSHIPS (CONTINUED)
M, Apr. 15 REAL ESTATE AS A SECURITY
W, Apr. 17 REAL ESTATE AS A SECURITY (CONTINUED)
M, Apr. 22 REAL ESTATE INVESTMENT FOR PENSION FUNDS
W, Apr. 24 REAL ESTATE INVESTMENT FOR PENSION FUNDS (CONTINUED)
M, Apr. 29 FOREIGN INVESTMENT IN U.S. REAL ESTATE
W, May 1 LAND RESOURCES AND AGRICULTURE INVESTMENT SHELTERS
M, May 6 CASE PROBLEM #3 DUE
W, May 8 FINAL EXAM

REAL ESTATE EQUITY INVESTMENT

Bus 850
Spring Semester 1985

Prof. James A. Graaskamp

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
M, Jan. 21	INTRODUCTION--POSITIONING FOR THE FUTURE	
	A. "What's Really Happening in the U.S.," John Naisbitt, Sept. 20, 1979.	Mimeo
	B. "When the World Runs Out of Oil," Steve Sherman, <u>Yankee Magazine</u> , Feb., 1977.	Mimeo
	C. "The Coming Entrepreneurial Revolution: A Survey," <u>The Economist</u> , Dec. 25, 1976.	Mimeo
	D. "Five Ways to Go Bust," <u>The Economist</u> , Jan., 1983.	Mimeo
	E. "The Next American Frontier," Robert Reich, <u>The Atlantic Monthly</u> , Mar., 1983.	Mimeo
	F. "Intrapreneurial Now," <u>The Economist</u> , Apr. 17, 1982.	Mimeo
	G. "Will Capitalism Survive?" Benjamin Rogge, <u>The MGIC Newsletter</u> , Oct., 1978.	Mimeo
	H. Business Brief, "America Cannot Afford Its Cost of Capital," <u>The Economist</u> , April 30, 1983.	Mimeo
W, Jan. 23	HISTORICAL DEVELOPMENT OF REAL ESTATE INVESTMENT METHODS	
	A. "The Future of the Real Estate Industry: Changing Supply Patterns," "Tomorrow's Changing Demand for Real Estate," and "The Future of the Real Estate Industry: New Directions and New Roles," John McMahan, <u>Real Estate Review Series</u> .	Mimeo
	B. "Modern Investment Theory and Real Estate Analysis," Peter E. Penny, <u>The Appraisal Journal</u> , Jan. 1982, pp. 70-99.	Mimeo
	C. "Managing Fundamentals," Peter Drucker, <u>The Best of Business</u> .	Mimeo
	D. Chapter 29, "National Economic Conditions and Trends," Noreen Beiro, <u>Development Review & Outlook</u> , 1983-84, ULI.	Mimeo

- E. "Real Estate Investment Strategy in the 1980's," Robert M. Ellis, Coldwell Banker, 1980. Mimeo
 - F. "Factors Shaping Development in the 80's," "Looking Forward: A View of Development in the Years Ahead," Robert Nahas and Harold Jansen, Urban Land, Dec., 1981. Mimeo
- M, Jan. 28 FUNDAMENTALS OF REAL ESTATE INVESTMENT ANALYSIS: MONOPOLY AND SPREAD
- A. Chapter 1-3, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. Text
 - B. "The Influence of Capital Market Theory on Real Estate Returns of the Value of Economic Analysis," Stephen Roulac, Practicing Law Institute. Mimeo
 - C. Chapter Fifteen, "Investment Analysis," Real Estate Syndication, Steve Jarchow, 1985. Mimeo
 - D. Chapter 25, "Trends in Real Estate Finance," Cecil E. Sears, Development Review & Outlook 1983-1984, ULI, 1983. Mimeo
 - E. "Investment Success Through Ratio Preference Analysis," Victor Trapasso, Real Estate Review, Winter 1983. Mimeo
 - F. "Real Estate Investment Analysis: IRR Versus FMRR," Stephen Messner & M.C. Findlay, III, The Real Estate Appraiser, July-Aug. 1975. Mimeo
- W, Jan 30 BASIC CASH FLOW CONCEPTS AND MRCAP (Assign Case #1)
- A. Chapters 4-7, 20-12, Real Estate Investment Stephen Pyhrr and James Cooper, 1982. Text
 - B. Chapter 9, "After-Tax Cash Flow from Operation," Tax Planning For Real Estate Investors, Second Edition, James Kau and C.F. Sirmans, 1982. Mimeo
 - C. "Inflation and the Real Estate Investor," Paul Wendt, The Appraisal Journal, July, 1977. Mimeo
 - D. "Real Estate Investment Returns of Taxable and Non-Taxable Investors," Richard Hanson, Coopers & Lybrand, Chicago, April 1982. Mimeo

- E. Chapter 14, "H. Walker: A Triplex Investment,"
Tax Planning For Real Estate Investors,
Second Edition, James Kau & C.F. Sirmans, 1982. Mimeo
- F. "Peril-Point Acquisition Prices," John
Crowther, Harvard Business Review,
September-October 1969. Mimeo
- M, Feb. 4 CHOICE OF REAL ESTATE OWNERSHIP
- A. Chapters 8-9, Real Estate Investment,
Stephen Pyhrr and James Cooper, 1982. Text
- B. Chapter Two, "Choice of Business Entity,"
Real Estate Syndication, Steve Jarchow,
1985. Mimeo
- C. "How to Structure Real Estate Investment
Management," Stephen Roulac, The Journal of
Portfolio Management, Fall 1981. Mimeo
- D. "Institutional Strategies for Real Estate
Equity Investment, John McMahan. Mimeo
- E. "Hybrid Investments: Alternatives," John
White and Donald Wiest, Jr., Mortgage
Banking, December 1984. Mimeo
- W, Feb. 6 TAX PLANNING ON ACQUISITION
- A. Chapters 13, 14, 15, Real Estate Investment
Stephen Pyhrr and James Cooper, 1982. Text
- B. "The Tax Reform Act of 1984, Its Impact on
Real Estate Transactions," Kenneth Leventhal
& Company, 1984. Mimeo
- C. Chapter 8, "The Depreciation Deduction,"
Tax Planning For Real Estate Investors,
Second Edition, James Kau and C.F. Sirmans,
1982. Mimeo
- D. "How to Evaluate (Or Structure) A Real
Estate Investment, E. Martin Davidoff and
Ralph J. Anderson, Jr., The Practical
Accountant, October 1984. Mimeo
- M, Feb. 11 TAX PLANNING FOR DISPOSITION (Case #1 Due)
- A. Chapters 16-17, Real Estate Investment
Stephen Pyhrr and James Cooper, 1982. Text
- B. "Impact of the 1984 Tax Act on Real Estate
Transactions," Brumbaugh, Williams, and Maas
Real Estate Newsletter, Coopers & Lybrand Mimeo

Bus 850, Spring 1985

- C. Chapter 10, "Taxes Due on Sale," Tax Planning For Real Estate Investors, Second Edition, James Kau and C.F. Sirmans, 1982. Mimeo
- D. "Section I: Below-Market Rate Loans," John Reed, Real Estate Investing Letter, Special Report. Mimeo
- W, Feb. 13 TAX PLANNING FOR DISPOSITION (CONTINUED)
(Assign Case #2--Clifford Part 1)
 - A. Chapters 16-17, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. Text
- M, Feb. 18 SPECIAL PROBLEMS AND TAX CONSTRAINTS ON REAL ESTATE INVESTMENTS
 - A. Chapter Nine, "Structuring Deductions," Real Estate Syndication, Steve Jarchow, 1985. mimeo
- W, Feb. 20 SPECIAL PROBLEMS AND TAX CONSTRAINTS ON REAL ESTATE INVESTMENT (CONTINUED)
 - A. "Historical Preservation Aspects of The Economic Recovery Tax Act of 1981," James A. Graaskamp, October 1982. Mimeo
 - B. "Rehabilitaion Expenditures for Certified Historic Structures Amortization," Federal Tax Coordinator. Mimeo ..
 - C. Real Estate Tax Ideas, Joel Miller, February 1983. Mimeo
- M, Feb. 25 ESTATE PLANNING AND TAXES
 - A. Chapters 25-27, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. Text
 - B. Chapter I, "Introduction to Estate and Gift Taxation," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
 - C. Chapter VIII, "The Concept of Gross Estate," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
 - D. Chapter XVIII, "Estate Tax--Marital and Orphan's Deductions," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo

Bus 850, Spring 1985

- E. Chapter XIX, "Estate Tax--Deductions, Expenses, and Losses," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sagg, 1982. Mimeo
- F. Chapter XXI, "Valuation," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sagg, 1982. Mimeo
- G. Chapter XXII, "Estate Tax Administration and Procedures," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sagg, 1982. Mimeo
- W, Feb. 27 ESTATE PLANNING (CONTINUED)
(Case #2 Due: Clifford Part 2--Assigned)
 - A. "Creating Value in Real Estate," Jay Shidler, Real Estate Forum, July 1982. Mimeo
 - B. "The New Marital Deduction Qualified Terminable Interest Trust: Planning and Drafting Considerations," Malcom Moore. Mimeo
 - C. "How State Death Taxes Affect Overall Estate Planning," Staff of J.K. Lasser Institute. Mimeo
- M, Mar. 4 ALTERNATIVE FEDERAL TAX PROPOSALS AND REAL ESTATE
- W, Mar. 6 EXCHANGES
 - A. Chapter 12, "Tax Deferred Exchanges," Tax Planning For Real Estate Investors, Second Edition, James Kau & C.F. Sirmans, 1982. Mimeo
 - C. "Computerized Exchange Evaluation Model," Jay Butler & Glenn Henderson, Jr., The Appraisal Journal, July 1977. Mimeo
- M, Mar. 11 REVIEW--CLIFFORD CASE PART 2 DUE
- W, Mar. 13 MID SEMESTER EXAM

SPRING RECESS
- M, Mar. 25 JOINT VENTURES
 - A.
 - B. "Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained," Roegge, Talbot, & Zinman, Fordham Law Review, Vol. 39, 1971. Mimeo

Bus 850, Spring 1985

W, Mar. 27 JOINT VENTURES

A.

M, Apr. 1 CORPORATE REAL ESTATE OWNERSHIP

A.

B. Chapter 1, "Four New Rules for Realty Trust Investors," New Investment Opportunities In Real Estate Investment Trusts, Audit, Inc. 1981.

Mimeo

C. "REIT Industry Seeing New Interest As It Positions Itself for the Future."

Mimeo

D. Part I, "Overview of Opportunities in Realty Trusts, Campbell, Audit Investment Services.

Mimeo

W, Apr. 3 LIMITED PARTNERSHIPS

B. Chapter Three, "Partnership Law," Real Estate Syndication, Steve Jarchow, 1985.

Mimeo

M, Apr. 8 LIMITED PARTNERSHIPS (CONTINUED)

A. "You Can Lose in the Wrong Syndication Investment," Paul Pilzer, Real Estate Review Spring 1984.

Mimeo --

B. "Structuring Real Property Acquisitions For Syndication," Paul Pilzer, Real Estate Review Summer 1984.

Mimeo

M, Apr. 10 LIMITED PARTNERSHIPS (CONTINUED)

A. "Transferring Limited Partnership Interests," Muth, Zulberti & Morris, The Real Estate Securities Journal, Winter 1981.

Mimeo

B. "Disposing of Syndication Property: Installment Sales & Wrap Around Mortgages = Pitfall," Dr. Mark L. Levine, RESSI Review, National Association of Realtors

Mimeo

C. Real Estate Newsletter, Coopers & Lybrand, February, 1983.

Mimeo

Bus 850, Spring 1985

- M, Apr. 15 REAL ESTATE AS A SECURITY
- A. Chapters 8-11, pp. 177-274, and Appendix 1, pp. 280-311, Real Estate Limited Partnerships Theodore Lynn and Harry Goldberg, 1983. Mimeo
- W, Apr. 17 REAL ESTATE AS A SECURITY (CONTINUED)
- A. Chapter 12, "Public Offerings," Steve Jarchow, 1985, Real Estate Syndication. Mimeo
- M, Apr. 22 REAL ESTATE INVESTMENT FOR PENSION FUNDS
- A. "The High Risks of Open-End Real Estate Funds," Claude Rosenberg, Jr., and Paul Sack The Journal of Portfolio Management, Fall 1975. Mimeo
- B. "Bank Trust Department Operation of Commingled Real Estate Funds," Mike Miles and Janelle Langford, Real Estate Issues, Winter 1978. Mimeo
- C. "Institutional Management of Pension Fund Investment in Real Estate: The Portfolio Perspective," Jaffe & Sirmans. Mimeo
- W, Apr. 24 REAL ESTATE INVESTMENT FOR PENSION FUNDS (CONTINUED)
- A. "Pursuing the Foreign Investor," G. Wendel Heineman, The Real Estate Appraiser and Analyst, November-December 1980. Mimeo --
- B. "Performance Evaluation of Commingled Funds," Mike Miles, and Art Estev. Mimeo
- C. "Institutional Strategies for Real Estate Investment," Stephen Roulac & Donald King, Jr. The Appraisal Journal, April 1978. Mimeo
- M, Apr. 29 FOREIGN INVESTMENT IN U.S. REAL ESTATE
- A.
- B. "Foreign Investment in U.S. Real Estate: Strategic Placement Analysis," Glenn Whitmore, Real Estate Report, First Quarter 1983. Mimeo

Bus 850, Spring 1985

C. "Tax Planning For Foreign Investment in U.S. Real Estate," Robert Bell and Dean Marsan, Real Estate Review, Summer 1984. Mimeo

D. "Foreign Investors in the United States: A Symposium," Henry Regeling, Real Estate Review, Fall 1984. Mimeo

W, May 1 LAND RESOURCES AND AGRICULTURE INVESTMENT SHELTERS

A. "American Farming, Old MacDonald Sold His Farm," The Economist, December 1, 1984. Mimeo

B. "Seven Benefits of Farmland Ownership," Landowner. Mimeo

C. "Building Net Worth With Tax Shelters." Mimeo

M, May 6 CASE PROBLEM #3 DUE

W, May 8 FINAL EXAM

BUSINESS 850
REAL ESTATE EQUITY INVESTMENT

Spring, 1986

Prof. James A. Graaskamp

I. Objectives:

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasized both readings, and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

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(Available at the University Bookstore).

Taxes 1986, Wisconsin Taxpayers Alliance. (Room 118)

Tax Planning for Real Estate Investors, James B. Kau and C.F. Sirmans, Prentice Hall, Inc.
(Available at University Bookstore).

Mimeograph Reading Packet available at Bob's Copy Shop in Randall Towers.

NOTE: ALL PAPERS AND EXERCISES TO BE HANDED IN SHOULD BE STAPLED AT UPPER LEFT HAND CORNER AND GIVEN A TITLE PAGE BUT LEFT WITHOUT PLASTIC BINDERS OR OTHER SIMILAR COVERS.

SCHEDULE OF TOPICS

Real Estate Equity Investment

850

<u>Class Periods</u>	<u>Topic</u>
W, Jan. 22	INTRODUCTION--POSITIONING FOR THE FUTURE (ASSIGN CONTINENTAL CASE #1)
M, Jan. 27	EVOLUTION OF REAL ESTATE INVESTMENT STRATEGIES & METHODS
W, Jan. 29	FUNDAMENTALS OF INVESTMENT: MONOPOLY, SPREAD, AND RISK MANAGEMENT
M, Feb. 3	REVIEW OF CRITICAL CASH FLOW MODELS AND RATIOS (CONTINENTAL CASE PRESENTATION) (HAND IN CASE #1)
W, Feb. 5	ALTERNATIVE FORMATS FOR THE INDIVIDUAL INVESTOR (ASSIGN CASE STUDY #2)
M, Feb. 10	FEDERAL AND STATE TAX IMPACTS ON STRATEGY (TV VIDEO LECTURE)
W, Feb. 12	TAX PLANNING ON ACQUISITION
M, Feb. 17	TAX PLANNING FOR DISPOSITION
W, Feb. 19	SPECIAL TAX PROBLEMS FOR REAL ESTATE INVESTMENT (GUEST SPEAKER)
M, Feb. 24	INDIVIDUAL INVESTMENT GOALS
M, March 3	POTENTIAL FEDERAL TAX REFORM
W, March 5	EXCHANGES (HAND IN CASE #2)
M, March 10	REVIEW OF CASE #2, ASSIGN CASE #3
W, March 12	LIMITED PARTNERSHIPS
M, March 17	LIMITED PARTNERSHIPS (CONTINUED)
W, March 19	* * * MID-SEMESTER EXAM * * *
W, April 2	INSTITUTIONAL REAL ESTATE ALTERNATIVES--PENSION FUND VIEWPOINT (REVIEW CASE #3, ASSIGN CASE #4)
M, April 7	COMMINGLED FUNDS (GUEST SPEAKER)

<u>Class Period</u>	<u>Topic</u>
W, April 9	COMMINGLED FUNDS (CONTINUED)
M, April 14	REAL ESTATE INVESTMENT TRUSTS
M, April 21	CORPORATE REAL ESTATE OWNERSHIP
W, April 23	INSTITUTIONAL JOINT VENTURE
M, April 28	REAL ESTATE UNITS AS A SECURITY
W, April 30	REAL ESTATE UNITS AS A SECURITY (CONTINUED)
M, May 5	FOREIGN INVESTMENT IN U.S. REAL ESTATE (CASE PROBLEM #3 DUE)
F, May 9	* * * FINAL EXAM * * *

REAL ESTATE EQUITY INVESTMENT

Bus. 850

Spring Semester 1986

Prof. James A. Graaskamp

<u>Class Period</u>	<u>Readings</u>	<u>Source</u>
W, Jan. 22	INTRODUCTION--POSITIONING FOR THE FUTURE (ASSIGN CONTINENTAL CASE #1)	
	A. "What's Really Happening in the U.S.," John Naisbitt, Sept. 20, 1979.	Mimeo
	B. "When the World Runs Out of Oil," Steve Sherman, <u>Yankee Magazine</u> , Feb., 1977.	Mimeo
	C. "The Coming Entrepreneurial Revolution: A Survey," <u>The Economist</u> , Dec. 25, 1976.	Mimeo
	D. "Five Ways to Go Bust," <u>The Economist</u> , Jan., 1983.	Mimeo
	E. "Intrapreneurial Now," <u>The Economist</u> , Apr. 17, 1982.	Mimeo
	F. "The Next American Frontier," Robert Reich, <u>The Atlantic Monthly</u> , Mar., 1983.	Mimeo
	G. "Will Capitalism Survive?" Benjamin Rogge, <u>The MGIC Newsletter</u> , Oct., 1978.	Mimeo
	H. "The Future of the Real Estate Industry: Changing Supply Patterns," "Tomorrow's Changing Demand for Real Estate," and "The Future of the Real Estate Industry: New Directions and New Roles," John McMahan, <u>Real Estate Review Series</u> .	
M, Jan. 27	EVOLUTION OF REAL ESTATE INVESTMENT STRATEGIES AND METHODS	
	A. "Modern Investment Theory and Real Estate Analysis," Peter E. Penny, <u>The Appraisal Journal</u> , Jan. 1982, pp. 70-99.	Mimeo
	B. "Managing Fundamentals," Peter Drucker, <u>The Best of Business</u> .	Mimeo
	C. "Real Estate Investment Strategy in the 1980'S, " Robert M. Ellis, Coldwell Banker, 1980.	Mimeo
	D. "Games the Stock Market Didn't Teach You, Stephen Roulac.	Mimeo

- E. "Looking Forward: A View of Development in the Years Ahead," Robert Nahas and Harold Jansen, Urban Land, Dec., 1981. Mimeo
- W, Jan. 29 FUNDAMENTALS OF INVESTMENT: MONOPOLY, SPREAD, AND RISK MANAGEMENT
- A. Chapter 1-3, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. Text
- B. Business Brief, "America Cannot Afford It's Cost of Capital," The Economist, Apr.30.1983. Mimeo
- C. "The Influence of Capital Market Theory on Real Estate Returns of the Value of Economic Analysis," Stephen Roulac, Practicing Law Institute. Mimeo
- D. "Measuring Real Estate Returns," John McMahan, Real Estate Issues, Fall/Winter, 1984. Mimeo
The Best of Business. Mimeo
- E. "Nine Reasons to Invest in Real Estate," Stephen Roulac & Co. Mimeo
- F. "A Differential Approach to Income Property Valuation: A New Measurement Technique," Stephen Sykes & Michael Young, The Appraisal Journal, April, 1981. Mimeo
- G. "Creating Value in Real Estate," The Shidler Organization. Mimeo
Review & Outlook, 1983-84, ULI. Mimeo
- H. Measuring the Performance of Real Estate Assets and Its Managers," Michael Young, Shlaes and Young Information Systems, Inc. Mimeo
- I. Chapter Fifteen, "Investment Analysis," Real Estate Syndication, Steve Jarchow, 1985. Mimeo
- J. Chapter 25, "Trends in Real Estate Finance," Cecil E. Sears, Development Review & Outlook 1983-1984, ULI, 1983. Mimeo
- K. "Investment Success Through Ratio Preference Analysis," Victor Trapasso, Real Estate Review, Winter 1983. Mimeo

- L. "Real Estate Investment Analysis: IRR Versus FMRR, Stephen Messner & M.C. Findlay, III, The Real Estate Appraiser, July-Aug. 1975. Mimeo
- M, Feb. 3 REVIEW OF CRITICAL CASH FLOW MODELS AND RATIOS (CONTINENTAL CASE PRESENTATION) (HAND IN CASE #1)
- A. Chapters 4-7, 20-12, Real Estate Investment Stephen Pyhrr and James Cooper, 1982. Text
- B. Chapter 9, "After-Tax Cash Flow from Operation," Tax Planning For Real Estate Investors, Third Edition, James Kau and C.F. Sirmans, 1985. Text
- C. "Inflation and the Real Estate Investor," Paul Wendt, The Appraisal Journal, July, 1977. Mimeo
- D. Chapter 14, "H. Walker: A Triplex Investment," Tax Planning For Real Estate Investors, Second Edition, James Kau & C.F.Sirmans, 1982. Mimeo
- E. "Peril-Point Acquisition Prices," John Crowther, Harvard Business Review, September-October 1969. Mimeo
- W, Feb. 5 ALTERNATIVE FORMATS FOR THE INDIVIDUAL INVESTOR (ASSIGN CASE STUDY #2)
- A. Chapters 8-9, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. Text
- B. Chapter Two, "Choice of Business Entity," Real Estate Syndication, Steve Jarchow, 1985. Mimeo
- C. "How to Structure Real Estate Investment Management," Stephen Roulac, The Journal of Portfolio Management, Fall 1981. Mimeo
- D. "Institutional Strategies for Real Estate Equity Investment, John McMahan. Mimeo
- E. "Hybrid Investments: Alternatives," John White and Donald Wiest, Jr., Mortgage Banking, December 1984. Mimeo

- M, Feb. 10 FEDERAL AND STATE TAX IMPACTS ON STRATEGY
 (TV VIDEO LECTURE)
- A. Chapters 13, 14, 15, Real Estate Investment
 Stephen Pyhrr and James Cooper, 1982. Text
- B.
- W, Feb. 12 TAX PLANNING ON ACQUISITION
- A. Chapters 5-8, Tax Planning for Real
 Estate Investors. Text
- B. Chapters 13, 14, 15, Real Estate Investment,
 Stephen Pyhrr and James Cooper, 1982. Text
- C. Chapter 8, "The Depreciation Deduction,"
 Tax Planning For Real Estate Investors,
 Second Edition, James Kau and C.F. Sirmans,
 1985. Text
- D. "How to Evaluate (Or Structure) A Real
 Estate Investment, E.Martin Davidoff and
 Ralph J. Anderson, Jr., The Practical
 Accountant, October 1984. Mimeo
- M, Feb. 17 TAX PLANNING FOR DISPOSITION
- A. Chapters 10-11, Tax Planning for Real
 Estate Investors. Text
- C. Chapters 16-17, Real Estate Investment
 Stephen Pyhrr and James Cooper, 1982. Text
- W, Feb. 19 SPECIAL TAX PROBLEMS FOR REAL ESTATE INVESTMENT
 (GUEST SPEAKER)
- A. Chapter 13, Tax Planning for Real Estate
 Investors. Text
- B. A Real Estate General Partnership: Apartment
 Building Investment, Chapter 15. Text

M. Feb. 24 INDIVIDUAL INVESTMENT GOALS

- A. "Maintaining a Comfortable Lifestyle After Retirement," The Financial Desk Book. Mimeo
- B. "Investment Planning," The Financial Desk Book. Mimeo
- C. "Estate Planning," The Financial Desk Book. Mimeo
- D. "Real Estate Indicators," The Financial Desk Book. Mimeo
- E. "Who Says Doctors Are Lousy Investors," Lawrence Farber. Mimeo
- F. "American Farming, Old MacDonald Sold His Farm," The Economist, December 1, 1984. Mimeo
- G. "Seven Benefits of Farmland Ownership," Landowner. Mimeo

W, Feb. 26 REAL ESTATE AND ESTATE PLANNING

- A. Chapters 25-27, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. Text
- B. "The New Marital Deduction Qualified Terminable Interest Trust: Planning and Drafting Considerations," Malcom Moore. Mimeo
- C. Chapter 1, "Introduction to Estate and Gift Taxation," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
- D. Chapter VIII, "The Concept of Gross Estate," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
- E. "Real Estate Tax Reform: Historic Perspectives and Economic Implications," Stephen Roulac & Co. 1985. Mimeo
- F. Chapter XVIII, "Estate Tax--Marital and Orphan's Deductions," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo

- G. Chapter XIX, "Estate Tax--Deductions, Expenses, and Losses," Federal and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
- H. Chapter XX, "Estate Tax--Charitable Deductions and Credits," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
- I. Chapter XXI, "Valuation," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
- J. Chapter XXII, "Estate Tax Administration and Procedures," Federal Estate and Gift Taxation, Briner, Robison, Rossen and Sogg, 1982. Mimeo
- K. "How State Death Taxes Affect Overall Estate Planning," Staff of J. K. Lasser Institute. Mimeo
- M, March 3 POTENTIAL FEDERAL TAX REFORMS
- W, March 5 EXCHANGES (HAND IN CASE #2)
 - A. Chapter 12, Tax Planning for Real Estate Investors. Text
 - B. Chapter 12, "Tax Deferred Exchanges," Tax Planning For Real Estate Investors, Second Edition, James Kau & C.F. Sirmans, '82. Mimeo
 - C. "Computerized Exchange Evaluation Model," Jay Butler & Glenn Henderson, Jr., The Appraisal Journal, July 1977. Mimeo
- M, March 10 REVIEW OF CASE #2 (ASSIGN CASE #3)
- W, March 12 LIMITED PARTNERSHIPS
 - A. Chapter Three, "Partnership Law," Real Estate Syndication, Steve Jarchow, 1985. Mimeo
- M, March 17 LIMITED PARTNERSHIPS (CONTINUED)
 - A. "You Can Lose in the Wrong Syndication Investment," Paul Pilzer, Real Estate Review Spring 1984. Mimeo

- B. "Structuring Real Property Acquisitions For Syndication," Paul Pilzer, Real Estate Review Summer 1984. Mimeo
- C. "Transferring Limited Partnership Interests," Muth, Zulberti & Morris, The Real Estate Securities Journal, Winter 1981. Mimeo
- D. "Disposing of Syndication Property: Installment Sales & Wrap Around Mortgages = Pitfall," Dr. Mark L. Leving, RESSI Review, National Association of Realtors Mimeo
- E. "Syndication Emerges to Transform the Real Estate Capital Market," Stephen Roulac. Mimeo
- W, March 19 * * * MID SEMESTER EXAM * * *
- W, April 2 INSTITUTIONAL REAL ESTATE ALTERNATIVES--PENSION FUND VIEWPOINT (REVIEW CASE #3, ASSIGN CASE #4)
 - A. "Institutional Management of Pension Fund Investment in Real Estate: The Portfolio Perspective," Jaffe & Sirmans. Mimeo
- M, April 7 COMMINGLED FUNDS
 - A. "The High Risks of Open-End Real Estate Funds," Claude Rosenberg, Jr., and Paul Sack The Journal of Portfolio Management, Fall 1975. Mimeo
 - B. "Bank Trust Department Operation of Commingled Real Estate Funds," Mike Miles and Janelle Langford, Real Estate Issues, Winter 1978. Mimeo
- W. April 9 COMMINGLED FUNDS (CONTINUED)
 - A. "Performance Evaluation of Commingled Funds," Mike Miles, and Art Estev. Mimeo
 - B. Chapter 26, "Mortgage Investment Determinants in With Commingled Funds," Kinney & Garrigan The Handbook of Mortgage. Handout

A. "Directions for Real Estate Investment Trusts," Stan Ross and Richard Klein, Real Estate Finance Journal, Winter 1986.

A. "Real Estate Equity Investments and the Institutional Lender: Nothing Ventured Nothing Gained," Roegge, Talbot, & Zinman, *Fordham Law Review*, Vol. 39, 1971.

A. Chapters 8-11, pp. 177-274, and Appendix 1, pp. 280-311, Real Estate Limited Partnerships Theodore Lynn and Harry Goldberg, 1983.

B. Chapter 12, "Public Offerings," Steve Jarchow, Real Estate Syndication, 1985.

A. "Foreign Investment in U.S. Real Estate: Strategic Placement Analysis," Glenn Whitmore, Real Estate Report, First Quarter 1983.

B. "Tax Planning For Foreign Investment in U.S. Real Estate," Robert Bell and Dean Marsan, Real Estate Review, Summer 1984.

C. "Foreign Investors in the United States: A Symposium," Henry Regeling, Real Estate Review, Fall 1984.

D. "Analysis of a Foreign Real Estate Venture
by U.S. Citizens."

F, May 9 * * * FINAL EXAM * * *

BUSINESS 850

REAL ESTATE EQUITY INVESTMENT

Spring 1988

Prof. James A. Graaskamp

I. OBJECTIVES:

To introduce students to the theoretical and practical problems of structuring real estate ownership to match investment strategy to constraints of federal tax law, leverage, risk characteristics of the property, and preferred management styles. Course emphasizes both readings and simulation by means of computerized cash flow investment models applied to selected cases. 3 credits.

II. GENERAL COURSE FORMAT:

Each week will have selected readings which are required. There will be a lecture on Mondays which, hopefully, will shed some light and organization on the readings selected. On Wednesdays, there will be a lecture or a lab session devoted to problem technique. There will be a two-hour exam at mid-semester and another at the end of the semester on these readings, and these exams will be 60 percent of your grade.

There will be four problem exercises which will represent 40 percent of your grade.

III. TEXTBOOKS:

Required: Mimeographed Reading Packet - Available at Bob's Copy Shop in Randall Towers.

Optional: Real Estate Investment--Strategy, Analysis, Decisions, Stephen A. Pyhrr and James Cooper; Warren, Gorham and Lamont, 1982. (Available at University Bookstore. Optional because tax law is obsolete.)

NOTE: ALL PAPERS AND EXERCISES TO BE HANDED IN SHOULD BE STAPLED AT THE UPPER LEFT HAND CORNER AND GIVEN A TITLE PAGE BUT LEFT WITHOUT PLASTIC BINDERS OR OTHER SIMILAR COVERS.

SCHEDULE OF TOPICS

Real Estate Equity Investment

Business 850

<u>DATE</u>	<u>TOPIC</u>
(1) W, Jan. 20	Introduction--Positioning for the Future
(2) M, Jan. 25	Performance of Real Estate in the Past
(3) W, Jan. 27	Elements of Real Estate Investment Strategy
(4) M, Feb. 1	Review of Cash Flow Fundamentals and Ratios
(5) W, Feb. 3	Alternative Formats for the Individual Investor
(6) M, Feb. 8	Tax Planning for Acquisition
(7) W, Feb. 10	Tax Planning for Disposition
(8) M, Feb. 15	Real Estate Investment & Personal Estate Planning
(9) W, Feb. 17	Principles of Estate & Gift Taxes
(10) M, Feb. 22	* * * MID-SEMESTER EXAM
(11) W, Feb. 24	Clifford Case
(12) M, Feb. 29	Exchanges
(13) W, Mar. 2	Involuntary Conversions
(14) M, Mar. 7	Group Investments & Risk Management
(15) W, Mar. 9	The General Partnership/Joint Venture
* * *	SPRING BREAK
(16) M, Mar. 21	The Limited Partnership
(17) W, Mar. 23	Limited Partnership (Continued)
(18) M, Mar. 28	The Master Limited Partnership
(19) W, Mar. 30	The Equity Trust
(20) M, Apr. 4	Real Estate Investment as a Security
(21) W, Apr. 6	Real Estate Investment as a Security (Continued)
(22) M, Apr. 11	The CMO & The Remic

<u>DATE</u>	<u>TOPIC</u>
(23) W, Apr. 13	Pension Fund Portfolio
(24) M, Apr. 18	Commingled Funds
(25) W, Apr. 20	Commingled Funds (Continued)
(26) M, Apr. 25	Real Estate Stocks
(27) W, Apr. 27	Measuring Performance of the Asset Manager
(28) M, May 2	Foreign Investment in U.S. Real Estate
(29) W, May 4	U.S. Investment in Foreign Real Estate
(30) F, May 6	* * * FINAL EXAM

READINGS FOR TOPICS

- | <u>DATE</u> | <u>TOPIC</u> |
|----------------|---|
| (1) W, Jan. 20 | Introduction--Positioning for the Future |
| | A. "When the World Runs Out of Oil" Steve Sherman, <u>Yankee Magazine</u> , February 1977. (mimeo) |
| | B. "The Coming Entrepreneurial Revolution: A Survey" <u>The Economist</u> , December 25, 1976. (mimeo) |
| | C. "Five Ways to Go Bust" <u>The Economist</u> , January 1983. (mimeo) |
| | D. "Intrapreneurial Now" <u>The Economist</u> , April 17, 1982. (mimeo) |
| | E. "The Next American Frontier" Robert Reich, <u>The Atlantic Monthly</u> , March, 1983. (mimeo) |
| | F. "Will Capitalism Survive?" Benjamin Rogge, <u>The MCIC Newsletter</u> |
| | G. "Developing an Investment Strategy for the Late 1980's" Charles C. Wetterer, <u>Real Estate Finance</u> , Spring 1986. (mimeo) |
| | H. "Modern Sardine Management" Samuel Zell, <u>Real Estate Issues</u> , Spring/Summer 1986. (mimeo) |
| | I. "Nine Reasons to Invest in Real Estate" Stephen Roulac & Co. (mimeo) |
| | J. <u>Patterns of Development</u> , George Sternlieb (with James W. Hughes), p. 211-282, Chapters 10-12 |
| (2) M, Jan. 25 | Performance of Real Estate in the Past |
| | A. "Measuring Real Estate Returns" John McMahan, <u>Real Estate Issues</u> , Fall/Winter, 1984. (mimeo) |
| | B. BOTTOM LINE, An Information Service of Liquidity Fund, NREI Summer, 1986. (mimeo) |
| (3) W, Jan. 27 | Elements of Real Estate Investment Strategy |
| | A. "Managing Fundamentals" Peter Drucker, <u>The Best of Business</u> . (mimeo) |
| | B. "Real Estate Investment Strategy in the 1980's" Coldwell Banker. (mimeo) |

- C. "Games the Stock Market Didn't Teach You" Stephen Roulac. (mimeo)
- D. Chapters 1-3, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. (text)
- E. Chapters 4-7, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. (text)
- F. "Inflation and the Real Estate Investor" Paul Wendt, The Appraisal Journal, July 1977. (mimeo)
- G. "Peril-Point Acquisition Prices" John Crowther, Harvard Business Review, September-October 1969. (mimeo)
- H. "Real Estate Investment Analysis: IRR versus FMRR" Stephen D. Messner and M. Chapman Findlay, III, The Real Estate Appraiser, July/August 1975, pp. 5-20. (mimeo)
- I. "Choice of Business Entity" Real Estate Syndication, Chapter 2, pp. 20-40, "Institutional Strategies for Real Estate Equity Investment," John McMahan, pp. 1-19. (mimeo)
- J. "Strategic Planning Leads to Increased Bottom Line" National Real Estate Investor, Christopher B. Leinberger, February 1986.
- K. Real Estate Investor's Deskbook, Alvin L. Arnold, Chapters 1-4, Warren, Gorham & Lamont, Inc., Boston, Mass., 1987. (mimeo)
- L. "A Look at Real Estate Duration" David J. Hartzell, David G. Shulman, Terence C. Langetieg, and Martin L. Leibowitz, 1987. (mimeo)
- M. Risk, Ruin & Riches: Inside the World of Big Time Real Estate, Jim Powell, Macmillan Publishing Company, New York, New York, 1986. (mimeo)
- N. "Creating Value in Real Estate; The Shidler Organization" Real Estate Forum, July 1982. (mimeo)
- O. "The British" Pension Fund Investments in Real Estate, Natalie A. McKelvy, Chapter six, Quorum Books, 1983. (mimeo)
- P. "What to Expect From Real Estate Investments" Pension Fund Investments in Real Estate, Natalie A. McKelvy, Chapter seven, Quorum Books, 1983. (mimeo)
- Q. Emerging Trends in Real Estate: 1988. (handout)

- (4) M, Feb. 1 Review of Cash Flow Fundamentals and Ratios
- A. Modern Investment Theory and Real Estate Analysis" Peter E. Penny, The Appraisal Journal, January, 1982, pp. 70-99. (mimeo)
 - B. Chapter 15, "Investment Analysis" Real Estate Syndication, Steve Jarchow, 1985. (mimeo)
 - C. "Investment Success Through Ratio Preference Analysis" Victor Trapasso, Real Estate Review, Winter, 1983. (mimeo)
 - D. "Setting Discount & Capitalization Rates" Roulac Real Estate Consulting Group, October 13, 1987. (mimeo)
- (5) W, Feb. 3 Alternative Formats for the Individual Investor
- A. Chapters 8-9, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. (text)
 - B. "A Case for Apartments--Executive Summary" Johnstown/Consolidated Institutional Advisors, Inc. (mimeo)
 - C. Chapter 4, Real Estate Investor's Deskbook, Alvin L. Arnold, Warren, Gorham and Lamont, Inc., Boston, Mass., 1987. (mimeo)
 - D. "Impacts of Changes in the Forms of Commercial Real Estate Ownership" Salomon Brothers, Inc., Anthony Downs, August 1987. (mimeo)
- (6) M, Feb. 8 Tax Planning for Acquisition
- A. Chapters 13-15, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. (text)
 - B. Tax Reform Act of 1986, Real Estate Newsletter, Coopers & Lybrand. (handout)
 - C. "Tax Legislation: Omnibus Budget Reconciliation Act of 1987" Kenneth Laventhol & Co., Special Information Bulletin, January 1988. (mimeo)
- (7) W, Feb. 10 Tax Planning for Disposition
- A. Chapters 16-17, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. (text)

(8) M, Feb. 15

Real Estate Investment & Personal Estate Planning

- A. "Maintaining a Comfortable Lifestyle After Retirement" The Financial Desk Book. (mimeo)
- B. "Investment Planning" The Financial Desk Book. (mimeo)
- C. "Estate Planning" The Financial Desk Book. (mimeo)
- D. "Individual Retirement Accounts" The Financial Desk Book. (mimeo)
- E. "Qualified Employee Benefit Plans" The Financial Desk Book. (mimeo)
- F. "Nonqualified (Excess Benefit) Plans" The Financial Desk Book. (mimeo)
- G. "Miscellaneous Employee Benefit Plans" The Financial Desk Book. (mimeo)
- H. "Social Security and Medicare" The Financial Desk Book. (mimeo)
- I. "Real Estate Indicators" The Financial Desk Book. (mimeo)
- J. "Who Says Doctors are Lousy Investors?" Lawrence Farber. (mimeo)
- K. Wisconsin TAXES 1988. (handout)
- L. "Growing Like the Trees" Richard Smith, John Hancock Mutual Life Insurance Co., 1986. (mimeo)

(9) W, Feb. 17

Principles of Estate & Gift Taxes

- A. Chapters 25-27, Real Estate Investment, Stephen Pyhrr and James Cooper, 1982. (text)
- B. "The New Marital Deduction Qualified Terminable Interest Trust: Planning and Drafting Considerations" Malcom Moore. (mimeo)
- C. Chapter I, "Introduction to Estate and Gift Taxation" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)
- D. Chapter VIII, "The Concept of Gross Estate" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)

- E. Chapter XVIII, "Estate Tax-marital and Orphan's Deductions" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)
- F. Chapter XIX, "Estate Tax--Deductions, Expenses, and Losses" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)
- G. Chapter XX, "Estate Tax--Charitable Deductions and Credits" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)
- H. Chapter XXI, "Valuation" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)
- I. Chapter XXII, "Estate Tax Administration and Procedures" Federal Estate and Gift Taxation, Briner, Robison, Rossen, and Sogg, 1982. (mimeo)
- J. "Valuing Fractional Interests in Closely Held Real Estate Companies" Robert Oliver, Real Estate Review, Spring 1986. (mimeo)

(10) M, Feb. 22

* * * MID-SEMESTER EXAM

(11) W, Feb. 24

Clifford Case

(12) M, Feb. 29

Exchanges

- A. Chapter 12, "Tax Deferred Exchanges" Tax Planning For Real Estate Investors, 2nd Edition, James Kau & C.F. Sirmans, 1982. (mimeo)
- B. "Computerized Exchange Evaluation Model" Jay Butler & Glenn Henderson, Jr., The Appraisal Journal, July 1977. (mimeo)

(13) W, Mar. 2

Involuntary Conversions

(14) M, Mar. 7

Group Investments & Risk Management

- A. "Wall Street Smells Big Dollars" Stephen Roulac, Investment Decisions/20. (mimeo)

(15) W, Mar. 9

The General Partnership/Joint Venture

- A. "Joint Venture Financing, A Case Study" Thomas Meador & Richard Garrigan, Real Estate Finance, Winter 1986. (mimeo)

- B. "Equity Leases: Structuring Tenant-Developer Joint Ventures" Menachem Rosenberg, Real Estate Review, Winter 1986. (mimeo)

* * *

SPRING BREAK

(16) M, Mar. 21

The Limited Partnership

- A. Chapter three, "Partnership Law" Real Estate Syndication, Steve Jarchow, 1985. (mimeo)
- B. Chapters 8-11, pp. 177-274, & Appendix 1, pp. 280-311, Real Estate Limited Partnerships, Theodore Lynn and Harry Goldberg, 1983. (mimeo)

(17) W, Mar. 23

Limited Partnership (Continued)

- A. "Transferring Limited Partnership Units on the Secondary Market" George Hamilton, Real Estate Finance, Fall 1986. (mimeo)

(18) M, Mar. 28

The Master Limited Partnership

- A. "Guide to Master Limited Partnerships" Alvin Arnold, Mortgage & Real Estate Executives Report, Dec. 15, 1986. (mimeo)
- B. "Master Limited Partnerships" Real Estate Newsletter, Coopers & Lybrand, Spring 1986. (mimeo)
- C. "Master Limited Partnerships--A Basic Lesson" Stock Research Real Estate, Salomon Brothers, Inc., Dec. 19, 1986. (mimeo)
- D. Olympia & York Water Street Finance Corporation Prospectus. (mimeo)
- E. Roulac's Strategic Real Estate, November 1987, Vol. 9, No. 11. (mimeo)
- F. Peat Marwick, March 1987, No. 87-1, Development for Real Estate Execs. (mimeo)

(19) W, Mar. 30

The Equity Trust

- A. "New Directions for Real Estate Investment Trusts" Stan Ross and Richard Klein, Real Estate Finance Journal, Winter 1986. (mimeo)

- B. "Changing REIT's Find Broader Interest and Acceptance" Robert Freedman, The Real Estate Finance Journal, Winter 1986, pp. 72-76. (mimeo)
- C. "New Twist Added to Finite-Life REIT's" William P. Balch, The Real Estate Finance Journal, Winter 1986, pp. 77-79. (mimeo)
- D. "An Encore Performance for REIT's" Michael Fallon, Corporate Design & Realty, November/December 1986. (mimeo)
- E. "Why Real Estate Investment Trusts Are Good Investments" Daniel Blumberg, Real Estate Review, Winter 1986. (mimeo)
- F. REIT vs. Common Stock Investments: An Historical Perspective" Real Estate Finance, Spring 1986. (mimeo)
- G. Chapter 1-3 (vary), Real Estate Investment Trusts: Tax, Securities, and Business Aspects, Stephen P. Jarchow, John Wiley & Sons, 1988. (mimeo)
- H. "Bargains in Real Estate" interview with Bob Frank, Barrons, pp. 6-52, October 5, 1987. (mimeo)

(20) M, Apr. 4

Real Estate Investment as a Security

- A. Chapter 12, "Public Offerings" Steve Jarchow, Real Estate Syndication, 1985. (mimeo)
- B. "The Securitization of Real Estate" The Journal of Real Estate Development, Vol. 1, No. 4, Spring 1986. (mimeo)
- C. "Meet Real Estate's New Czars: The Middlemen" Business Week, October 5, 1987, pp. 98-101. (mimeo)
- D. Risk, Ruin & Riches: Inside the World of Big Time Real Estate, Jim Powell, Macmillan Publishing Company, New York, New York, 1986. (mimeo)

(21) W, Apr. 6

Real Estate Investment as a Security (Continued)

(22) M, Apr. 11

The CMO & The Remic

- A. "An Introduction to Real Estate Residual Value Certificates" Thomas M. Poaps, Real Estate Finance, Winter 1986. (mimeo)

- B. "REMIC's: A Milestone in the Evolution of Mortgage Securities" Kenneth Levanthol & Company.
- C. Sections VI and VIII, "Developments & Trends in the Secondary Mortgage Market" Mortgage Backed Securities, Kenneth G. Love, 1987-88 Edition, Clark Boardman Co., Ltd., New York, New York, 1987. (mimeo)

<u>DATE</u>	<u>TOPIC</u>
(23) W, Apr. 13	Pension Fund Portfolio A. "Real Estate: Can Institutional Portfolios Be Efficiently Diversified Without It?" Ronald A. Gold, JMB Institutional Realty Corporation, 1986. (mimeo) B. "Diversification Categories in Investment Real Estate" David Hartzell, John Hekman Mike Miles, Salomon Brothers, December, 1986. (mimeo) C. "Optimal Real Estate Portfolios: A New Look" David J. Hartzell, University of Texas, 1986. (mimeo) D. Chapter 9, "Direct Investing" <u>Pension Funds Investment in Real Estate</u>, Natalie McKelvy, Quorum Books, 1983. (mimeo) E. "Managing Real Estate Portfolios" <u>Real Estate Research</u>, Paul B. Firstenberg, Stephen A. Ross, Randall C. Zisler, November 16, 1987. (mimeo) F. "Managing Real Estate Portfolios, Part 3: A Close Look at Equity Real Estate Risk" <u>Real Estate Research</u>, Stephen A. Ross, Randall C. Zisler, November 16, 1987. (mimeo) G. "Stock & Bond Market Volatility & Real Estate's Allocation" <u>Real Estate Research</u>, Stephen A. Ross, Randall C. Zisler, November 16, 1987. (mimeo) H. "Real Estate Transactions by Exempt Entities; Techniques and Taxability" Lewis R. Kaster, Esq., Copyright New York, New York, 1986. (mimeo) I. Pension Fund Glossary (mimeo) J. Pension Fund Environmental Scan (mimeo)
(24) M, Apr. 18	Commingled Funds A. Chapter 8. "The Commingled Funds" <u>Pension Funds In Real Estate</u>, Natalie McKelvy, Quorum Books, 1983. (mimeo)

- B. Institutional Strategies for Real Estate Equity Investment" John McMahan. (mimeo)
- C. "The NCREIF Real Estate Performance Report, Third Quarter 1987 Results" National Council of Real Estate Investment Fiduciaries and Frank Russell Company. (mimeo)

(25) W, Apr. 20

Commingled Funds (Continued)

(26) M, Apr. 25

Real Estate Stocks

- A. "Bank Trust Department Operation of Commingled Real Estate Funds" Mike Miles & Janelle Langford, Real Estate Issues, Winter 1978. (mimeo)
- B. "Pension Funds and Developers: Forging A New Partnership" Urban Land, June 1986. (mimeo)
- C. "Real Estate Stocks Monitor" Alex Brown & Sons, Inc., February 1987. (mimeo)

(27) W, Apr. 27

Measuring Performance of the Asset Manager

- A. "Performance Evaluation of Commingled Funds" Mike Miles and Art Estev. (mimeo)
- B. Chapter 26, "Mortgage Investment Determinants in With Commingled Funds" Kinney & Garrigan, The Handbook of Mortgage. (mimeo)
- C. "Leverage, Nonrecourse Debt, and Property Returns" Robert A. Feldman, Real Estate Research, June 18, 1987. (mimeo)

(28) M, May 2

Foreign Investment in U.S. Real Estate

- A. "Foreign Investment in U.S. Real Estate: Strategic Placement Analysis," Glenn Whitmore, Real Estate Report, First Quarter, 1983. (mimeo)
- B. "Tax Planning for Foreign Investment in U.S. Real Estate" Robert Bell and Dean Marsan, Real Estate Review, Summer 1984. (mimeo)
- C. "Pursuing the Foreign Investor" G. Wendel Heineman, Real Estate Review, pp. 45-47. (mimeo)
- D. "The Court's Opinion" The Real Estate Appraiser and Analyst, November/December 1980, p. 34. (mimeo)

E. "Foreign Investors in the United States: A Symposium"
Henry Regeling, Real Estate Review, Fall 1984.
(mimeo)

F. "Analysis of a Foreign Real Estate Venture by U.S.
Citizens." (mimeo)

(29) W, May 4 U.S. Investment in Foreign Real Estate

(30) F, May 6 * * * FINAL EXAM

Business 850
Mid-Semester Equity Investment Exam

Wednesday, March 30, 1977

Graaskamp & Robbins

I. Define and discuss the following terms and concepts as they have appeared in the Real Estate Equity Investment course. Write on five of the following: (25%)

- A. Five financial tests in MR CAP which would indicate the investor paid too much for the real estate property.
- B. Identify two tax shelter strategies available in the reformed gift and estate tax law of 1976.
- C. Identify four basic issues in analyzing income tax characteristics of a real estate investment.
- D. What is the minimum tax and its concept?
- E. Why is a single family home a tax shelter investment?
- F. Define investment yield in real estate.

II. Write on one of the following two questions: (35%)

- A. Compare and contrast the risk analysis system put forward by Steve Pyhrr, Michael Young, and Mike Miles.

OR

- B. Discuss the constraints imposed on tax shelter investment strategies of the individual with very high earned income imposed by both the income tax reform and estate tax reforms of 1976.

III. Write on one of the following two questions: (20%)

- A. Discuss the limitations of the limited partnership form of ownership from the viewpoint of the general partner-sponsor.

OR

- B. Discuss the disadvantages of the limited partnership from the viewpoint of a wealthy limited partner with business management ability who is in need of tax shelter immediately.

IV. Explain and check the following Cash Flow elements. (Show all work, you will be graded on how you attempt the solution as well as the answer derived): (20%)

- A. What is the Amount of the After Tax Net Worth at the end of Year 3 and end of Year 4.
- B. Why is Change In After Tax Net Worth at end of Year 4 negative? If this is a problem suggest corrective action.
- C. Following the sale of the property at the end of Year 4, determine the Modified Internal Rate of Return.
- D. Determine the Present Value of Project Before Taxes at the end of Year 4.

P R J F J R M A
P R J F J R M A
INVESTMENT ANALYSIS OF
850 MIDTERM EXAM
FOR
JAG ENTERPRISES

* GROSS RENT	\$ 52310.	* RATE OF GROWTH OF GROSS RENT	.0476
* EXPENSES	\$ 9470.	* RATE OF GROWTH OF EXPENSES	.0566
* R E TAXES	\$ 9216.	* RATE OF GROWTH OF R E TAXES	.0073
INCOME TAX RATE	.3000	PROJECT VALUE GROWTH OF	6.0000
* VACANCY RATE	.0500	WORKING CAPITAL LOAN RATE	.1400
EQUITY DISCOUNT RATE	.180	EXTRAORDINARY EXPENSES	\$ 1000.
RESALE COST	.0700	REINVESTMENT RATE	.0410
WKG CAPITAL RS	\$ 600.	CAPITAL RESER INTEREST RATE	.0300
INITIAL COST	\$ 240000.	INITIAL EQUITY REQUIRED	\$ 45600.

ALL '*' VALUES ARE AVERAGE AMOUNTS FOR HOLDING PERIOD.

C O M P O N E N T S U M M A R Y

TITLE	PCT. DEPR	BEGIN USE	USEFUL LIFE	DEPR METHOD	COST	SCH
LAND	.00	1	0.	0	\$ 40000.	0
BUILDING	1.00	1	35.	4	\$ 165300.	0
OTHER	.80	1	20.	4	\$ 34700.	0
REFURBISH	1.00	4	7.	2	\$ 11000.	0

M O R T G A G E S U M M A R Y

TITLE	INTR RATE	BEGIN YR.	END YR.	TERM	ORIG BALC	PCT VALUE
FIRST ASSUMED MORTGAGE	.0775	1	3	20	\$ 180000.	.750
SELLERS 2ND MORTGAGE	.0850	1	3	0	\$ 15000.	.063
REFINANCE MORTGAGE	.0800	4	24	20	\$ 190000.	.757

195

195000

CASH FLOW ANALYSIS

	1	2	3	4
1 GROSS RENT	47334.	49701.	52186.	54795.
2 LESS VACANCY	2367.	2485.	2609.	2740.
3 LESS REAL ESTATE TAXES	9000.	9270.	9270.	9270.
4 LESS EXPENSES	9400.	8904.	9438.	10005.
5 NET INCOME	26567.	29042.	30868.	32781.
6 LESS DEPRECIATION	9687.	9188.	8717.	9843.
7 LESS INTEREST	15050.	14648.	14214.	15081.
8 TAXABLE INCOME	1831.	5205.	7938.	7857.
9 PLUS DEPRECIATION	9687.	9188.	8717.	9843.
10 LESS PRINCIPAL PAYMENTS	4902.	5304.	5739.	4041.
11 CASH THRUW-OFF	6615.	4089.	10916.	13659.
12 LESS TAXES	549.	1562.	2381.	2357.
13 LESS RESERVES AT 200.000	200.	200.	200.	200.
14 CASH FROM OPERATIONS	5866.	7328.	8334.	11047.
15 WORKING CAPITAL LOAN(CUM B)	0.	0.	0.	0.
16 DISTRIBUTABLE CASH AFR TAX	5866.	7328.	8334.	11047.
17 TAX SAVING ON OTHER INCOME	0.	0.	0.	0.
18 SPENDABLE CASH AFTER TAXES	5866.	7328.	8334.	11047.

CASH FLOW ANALYSIS

1 2 3 4

MARKET VALUE

19 BY METHOD - 6 - AT .0150	243600.	247254.	250963.	254727.
20 LESS RESALE COST	17052.	17308.	17567.	17831.
21 LESS LOAN BALANCES	190098.	184793.	179055.	185259.
22 PLUS CUM. CASH RESERVES	818.	1043.	1274.	1512.
23 B/4 TAX NET WORTH	37268.	46195.	55615.	52450.
24 CAPITAL GAIN (IF SOLD)	-7341.	2168.	11728.	22911.
25 CAPITAL GAINS TAX	-1101.	325.	1759.	3437.
26 INCOME TAX ON EXCESS DEP	1073.	1996.	2778.	3426.
27 TOTAL TAX ON SALE	742.	2321.	4537.	6863.
48 AFTER TAX NET WORTH	36526.	43874.	51078.	45587.

YEAR OF ANALYSIS

	1	2	3	4
BEFORE TAX RATIO ANALYSIS				

28 RETURN ON NET WORTH B/4 TAXES	-.0376	.4834	.4402	.1877
29 CHANGE IN NET WORTH B/4 TAXES	-8332.	8927.	9419.	-3165.
30 CASH RTN ON ORIG CASH EQUITY	.1451	.1993	.2394	.2995
31 PERCENT ORIG EQUITY PAYBACK	.1286	.2893	.4721	.7144
32 PRESENT VALUE OF PROJECT	232189.	240310.	241449.	

YEAR OF ANALYSIS

	1	2	3	4
AFTER TAX RATIO ANALYSIS				

33 <u>RETURN ON NEW WORTH AFT TAXES</u>	-.0704	.4018	.3541	.1088
34 CHANGE IN NET WORTH AFT TAXES	-9074.	7348.	7203.	-5491.
35 <u>CASH RTN ON ORIG CASH EQUITY</u>	.1286	.1607	.1828	.2423
36 PERCENT ORIG EQUITY PAYBACK	.1286	.2893	.4721	.7144
37 PRESENT VALUE OF PROJECT	230925.	236743.	235878.	

38 NET INCOME-MARKET VALUE RTO	.1091	.1175	.1230	.1287
39 LENDER BONUS INTEREST RATE	.0000	.0000	.0000	.0000
→ 40 DEFAULT RATIO	.8103	.7671	.7408	.7007

YEAR OF ANALYSIS

	1	2	3	4
MODIFIED INTERNAL RATE OF RETURN ANALYSIS				

RETURN ANALYSIS WITHOUT SALE

41 CUM. AFT TAX SPENDABLE CASH	5866.	13434.	22319.	34281.
42 MOD. I.R.R. ON ORIG EQUITY	-.8714	-.4572	-.2119	-.0688
43 MOD. I.R.R. ON CUM. EQUITY	-.8714	-.4572	-.2119	-.0689

RETURN ANALYSIS WITH SALE

44 CUM. CASH <u>LESS ORIG EQUITY</u>	-3208.	11708.	27797.	34268.
45 CUM. CASH <u>LESS CUM. EQUITY</u>	-3208.	11708.	27797.	34268.
46 MOD. I.R.R. ON ORIG EQUITY	-.0704	.1211		
47 MOD. I.R.R. ON CUM. EQUITY	-.0704	.1211		

ENTER '1' FOR RESTART TO PROCESS NEW DATA FILE '0' TO QUIT.

Steven Tabb
5-18-77

Real Estate Equity Investment 850
Final Exam

Wednesday, May 18, 1977

James A. Graaskamp
Michael L. Robbins

30% I. Identify the significant real estate investment attributes and investor limitations for three (3) of the following:

- A. Real estate equity investment trust
- B. Farm investment corporations
- C. Tax exempt organization investment in real estate
- D. Oil and gas syndications

20% II. Discuss trends and impact in next decade toward control of real estate investments as securities as developed in Roulac and readings on condominiums.

30% III. Discuss one of the following subjects:

A. Is it probable that real estate ^{investment properties} could out-perform ^{bank} common stocks to the end of our oil in this century as it has in the past 25 years? Supply a set of axioms and argue your position.

B. What types of screens and asset allocation criteria should be used to select and rank real estate investments for a ^{national} ~~bank~~ ^{managed pension fund}? Supply a set of objectives which generate suggested screens.

20% IV. Orvil P. Anderson is back; this time with a proposal for an exchange. Orvil owns a property with an appraised fair market value of \$175,000, an adjusted basis of \$75,000 and a mortgage of \$50,000. Orvil would like to swap properties with his brother-in-law, Mert Mizer, whose property has an appraised fair market value of \$275,000, a mortgage of \$100,000 and a basis of \$125,000.

Orvil has proposed to Mert that he refinance for \$150,000 in this tax year and then they would swap even in the next tax year.

What is the tax effect on each party?

Business 850, Mid-Semester Exam
Real Estate Equity Investment

March 23, 1983

Prof. James A. Graaskamp

- I. (20%) Write a short paragraph on five of the following concepts as developed in this course. (4 points each)
 1. Political exposures of real estate investment (Graaskamp)
 2. Measuring profits in uncertain times (Drucker)
 3. Seven major trends in the U.S. (Naisbitt)
 4. Inflation and the real estate investor (Wendt)
 5. Three conditions for real property price appreciation (Coldwell Banker)
 6. Five ways to go bust
- II. (20%) Outline step by step the procedure necessary to calculate cash flow from a sale of depreciable real estate with excess depreciation taken by the seller.
- III. (20%) Write a short summary of the process required by one of the following systematic procedures:
 1. How does one analyze the tax implications of disposition of real estate?
 2. Measurement of comparative pricing, returns, and risk of real estate vs. common stock as seen by Roulac, Pyhrr, and Cooper.
- IV. (20%) Give two examples of investment planning for real estate ownership which accomplishes each of the following:
 1. Conversion of ordinary income to capital gain
 2. Deferral of capital gain tax
 3. Reduction of estate tax
- V. (20%) Discuss the impact of investment real estate ownership on estate planning and transfer and suggest the role of the expert counselor.

REAL ESTATE EQUITY INVESTMENT

Mid Semester Exam

March 15, 1985

Prof. James A. Graaskamp

- I. - 25% Write in sentence outline form the historical development presented in one of the following articles.
 - A. The historical development of modern investment theory and real estate analysis - as presented by Peter Penney.
 - B. The future of the real estate industry as anticipated by John McMahan.
- II. - 24% Briefly describe the thrust or message in three of the following articles.
 - A. "Managing Fundamentals," Peter Drucker, The Best of Business.
 - B. Chapter Fifteen, "Investment Analysis," Real Estate Syndication, Steve Jarchow, 1985.
 - C. "Inflation and the Real Estate investor," Paul Wendt, The Appraisal Journal, July, 1977.
 - D. Chapter Two, "Choice of Business Entity," Real Estate Syndication, Steve Jarchow, 1985.
- III. - 30% Write on Three of the following strategy questions.
 - A. When would you use the new marital deduction Q-TIP Trust?
 - B. What set of conditions would suggest the use of a real estate exchange rather than sale of the property, payment of taxes, and purchase of a new piece of real estate?
 - C. When would it might be appropriate to acquire control of a property through a Master lease ala Jay Schidler rather than purchase?
 - D. Where is their opportunity to mismatch interest income and expense for seller and buyer.
- IV. - 21% Fill in the attached blank form writing neatly and concisely.

MID SEMESTER SPRING EXAM

Tax Ploy - Give example - available under 1984 law.

Treatment available under proposed treasury reforms for 1985-1986 tax bill.

1. Reduction of marginal tax rate and deferral of income tax using depreciation.

- use the ACRS tables to compute depreciation on an apartment with a depreciable life of 18 years. This reduces taxable income and defers payment of tax until sale. It may then be converted to capital gain tax, further reducing the rate.

2. Sale of a two million dollar office building on non recourse and contract with 5% down and 9% interest, 25 year term.

- in this situation, a sale and leaseback might be a good idea. If you are currently occupying the building you might be willing to sell on these terms and then lease it back to get the current annual deduction as an operating expense.

3. Postponing capital gains taxes.

- implement a tax deferred exchange. If no gain is realized, no taxes will be paid at the time of transaction. Basis in property acquired will be basis in old property + additional debt - boot. Capital gain will then be paid on disposition of new property.

4. Avoiding capital gains.

- capital gains tax can be avoided by dying and leaving property to heirs, who take a stepped up basis. Or could use a trust form of transfer where purchaser has no control over funds after deposited.

5. Tax investment credit for rehabilitation.

- substantially rehabilitate a building certified as a historic structure leaving 75% of the existing walls in tact. Can receive an ITC for 25% of cost of rehabilitation.

REAL ESTATE EQUITY INVESTMENT - Bus. 850

Final Exam, Spring 1985

Wednesday, May 8, 1985

Prof. James A. Graaskamp

- I. (20%) Briefly identify all potential disadvantages of a limited partnership investment to the potential investor and then provide an example of how those who structure and draft partnership agreements have tried to reduce that possible disadvantage of risk. It may be that certain disadvantages have not been remedied, even partially, and if so, indicate why you think this is so.
- II. (20%) Compare and contrast the relative advantages and disadvantages of an open end commingled fund and a finite real estate investment trust as a vehicle for pension fund investment.
- III. (20%) Write on one of the following:
 - A. Discuss the income tax advantages and disadvantages for foreign investors placing money in United States real estate investment. Identify significant trade-offs, if any, between public disclosure and tax treatment.
 - OR
 - B. Discuss concepts of investment liquidity, diversification, fiduciary risk, and a core portfolio as it relates to institutional management of pension fund investment in real estate.
- IV. (20%) Discuss the limited partnership as a potential security under both federal and state laws and the controls imposed by Regulation D or NASD.
- V. (20%) Compare and contrast the benefits of the investment tax credit, accelerated depreciation, and the capital gains tax opportunities for a land and commercial buildings developer who is choosing between ownership of the project as a private corporation, a sub-chapter corporation or a joint venture partnership.

FINAL EXAM BUSINESS 850

Monday, May 5, 1986

Prof. James A. Graaskamp

WRITE ON FOUR OF THE FOLLOWING QUESTIONS: 25% EACH

- I. Compare and contrast the advantages and disadvantages of pension fund investment in open end, closed end, or segretated accounts real estate investment pools.
- II. Discuss the major accounting and appraisal issues which make performance evaluation of a real estate investment fund difficult in terms of comparability to other funds and between fiscal periods.
- III. Outline the significant exemptions of real estate securities from regulation by the SEC. Do you think real estate investment marketing people should be permitted such broad latitude of exemptions?
- IV. Discuss the possible advantages and disadvantages specifically available to foreign investment in U.S. real estate relative to tax laws and other constraints.
- V. Compare what is meant by structuring a real estate investment for a tax shelter syndication as compared to what is meant by structuring for a private estate management concern.

Business 850

Real Estate Equity Investment
Six Weeks Exam

Spring Semester 1987
Monday, February 23, 1987

Prof. James A. Graaskamp

- I. If you had \$10 million to invest in real estate, over and beyond an equal amount of stocks and bonds, how would you rationalize your investment hope if oil is in declining supply, America will restructure socially, capitalism is doubtful, and urban environments are politically unstable?
- II. What are the key ratios and accounting baseline on which Steve Jarchow or Victor Trapasso seek investment success?
- III. What are the basic concepts in estimating liquidity needs for estate tax and what provision should the real estate investor make to anticipate those needs?
- IV. Discuss the issues that need to be addressed in tax planning for a property to be acquired as discussed by Pyhrr and Cooper and then modified by Coopers and Lybrand in their 1986 tax letter.
- V. Identify five tax ploys that remain in the 1986-87 tax law that may permit postponement or avoidance of capital gains tax.

NAME _____

REAL ESTATE EQUITY INVESTMENT 850

FINAL EXAM, SPRING, 1987

Page 1

- 25% I. Develop an essay on one of the following two questions:
- A. Discuss structuring and important features of a general partnership/joint venture agreement.
- OR
- B. Discuss the real estate exchange in terms of tax treatment and investment objectives of the parties.

NAME _____

REAL ESTATE EQUITY INVESTMENT 850

FINAL EXAM, SPRING, 1987
PAGE 2

- 25% II. Discuss real estate equity investment strategies and alternatives for the pension fund investment portfolio.

NAME _____

REAL ESTATE EQUITY INVESTMENT 850

FINAL EXAM, SPRING, 1987

PAGE 3

25% III. Write on one of the following two questions:

A. Discuss alternative methods and technical problems in measuring performance and comparative performance of the real estate equity investment.

OR

B. Compare the relative performance of owned real estate, REIT shares, and common stock in terms of the research studies and discussions in the course readings.

NAME _____

REAL ESTATE EQUITY INVESTMENT 850

FINAL EXAM, SPRING, 1987

PAGE 4

- 25% IV. On the attached grid sheets fill in each box to indicate the degree to which each real estate structure possesses the listed attribute.

ATTRIBUTE

ALTERNATIVE RESPONSES

- | | |
|---|--|
| 1. Control of Real Estate Management by Investor | None, indirectly by electing board, direct management participation as an owner. |
| 2. Limit of Liability for Investors | Limited to investment, unlimited, agreement to be assessable. |
| 3. Liquidity | Very marketable, controlled resale, long-term commitment. |
| 4. Double Taxation | No tax, single tax audit, double tax entity. |
| 5. Regulation as a Security | Never, sometimes exempt, always regulated. |
| 6. Ease of Raising Large Amounts of Capital | Practical limitation on number of investors, national marketing and expandable number of shares, unlimited growth potential. |
| 7. Flexibility in Terms of Active Management or Buying and Selling Assets | Asset manager is autonomous, asset manager can only be discharged for malfeasance, real estate manager serves at the will of the investor. |

ATTRIBUTE	REIT	MLP	SUBCHAPTER S	REGULAR CORPORATION
1. Control of Real Estate Management by Investor	indirect	none	direct	indirect
2. Limit of Liability for Investors	limited to investment	limited to investment	limited to investment	limited to investment
3. Liquidity	very marketable	very marketable	controlled resale	very marketable
4. Double Taxation	single tax	single tax	single tax	double tax
5. Regulation as a Security	always regulated	always regulated	never	always regulated
6. Ease of Raising Large Amounts of Capital	practical limitations	practical limitations	<i>practical or</i> legal limitation to 35	unlimited growth potential
7. Flexibility in Terms of Active Management or Buying and Selling Assets	autonomous	discharge for malfeasance	at the will of the investors	at the will of investors

ATTRIBUTE	GENERAL PARTNERSHIP	LIMITED PARTNERSHIP	OPEN END CO-MINGLED FUND	CLOSED END CO-MINGLED FUND
1. Control of Real Estate Management by Investor	direct participation	none	none	none
2. Limit of Liability for Investors	none <i>(unlimited liability)</i>	limited to investment <i>assetable</i>	limited to investment	limited to investment
3. Liquidity	long term commitment	controlled resale or long term commitment	controlled resale	long term commitment
4. Double Taxation	single tax	single tax	no tax	no tax
5. Regulation as a Security	never	sometimes exempt	never	never
6. Ease of Raising Large Amounts of Capital	practical limitations	practical limitations	unlimited	practical limitations
7. Flexibility in Terms of Active Management or Buying and Selling Assets	autonomous	substitution for malfeasance	served at will of investor	served at will of investor

BUSINESS 850

REAL ESTATE EQUITY INVESTMENT

MID-SEMESTER EXAM

Wednesday, February 24, 1988

Prof. J. A. Graaskamp

- I. Long-term investment real estate is based on many implicit hopes and assumptions about the future of the community and the country. Identify at least eight major soft hopes and the possible risk management factors for each that become part of a real estate investment strategy for a real estate investor. (20 points)
- II. Write on ONE of the following two questions based on your readings and lecture: (25 points)
 - A. Identify and define all the major tools for quantifying risk as a tolerance for surprise in a real estate income investment.
-- OR --
 - B. Identify the major tools and issues for measuring rate of return for a real estate income property investment.
- III. Write on ONE of the following two questions: (25 points)
 - A. Identify the alternative real estate investment formats available to the individual investor and the critical factors, pro and con, for each.
-- OR --
 - B. Identify the critical tax planning issues for the individual investor planning to acquire income property investment.
- IV. Identify the critical issues in planning the estate tax strategy for personal estates dominated by real estate income property investments. (15 points)
- V. Identify your favorite article in the 850 reading packet up to this exam, briefly identify the contents, and then explain why it had more impact than most. (15 points)

Business 850 Mid-Semester Exam Key

I-1 Market analysis errors:

- Unspecified research direction
- Unexplained statistics
- Misspecified supply and demand
- Uncorrelated supply and demand
- Inattention to economic indicators
- Omission of primary data

I-2 The Coase Theorem is concerned with the problem of social cost. He argued that in a world with 0 transaction costs, adjacent users of property will be able to negotiate between themselves in cases of inharmonious uses when incentives exist to do so. Thus it doesn't make any difference which party is initially assigned the property rights for efficient use of society's resources if incentives exist for negotiation.

I-3 The irrelevance of the capital structure argument is a challenge by Modigliani & Miller that leverage acquired as a result of corporate debt policy is inconsequential because investors invent their own margin with homemade leverage in stock shares. Application to real estate is difficult because of the inherent assumptions. For example for arbitrage to work, personal and corporate leverage must be perfect substitutes without transaction costs, potential bankruptcy costs, or income tax costs. The income tax favors the debt position. It also assumes efficient market information which is seldom found in real estate.

I-4 Basic ratios and limitations of ratio analysis. Some of the basic ratios are loan to value ratio, default ratio, asset turnover ratio, operating expense ratio, profitability ratio, profit margin ratio, return to equity on total investment and return on equity ratio. The limitations include understating operating costs. Ratios depend on viewpoint of the analyst.

II-1 Reinvestment rate assumptions is very low relative to turnover real estate and in addition. The resale price may be falling or there is low interest only mortgage which is failing to provide equity buildup.

II-2 Negative cash from operations implies a bug in the program or a large initial working capital reserve to cover deficits.

II-3 All cash is being directed to amortization of the mortgage and the largest portion of the debt service constant is principal so that rents must be very very high.

IV. Peril point pricing presumes that a price earnings ratio is the reciprocal of the ~~cash~~ earnings from net income or earned income view to the degree that the reciprocal exceeded the current rate of distributable earnings. If this rate exceeds cash dividend, then it implies a certain rate of growth over time and many times these growth rates are unreasonable so that Ellis recommends proper timing, loading the overall rate for the expected cash on cash dividend, and assumptions which reasonably price the property for sale in order to realize capital gains.

- VI-A John McMahan sees gradual insitutionalization of ownerhsip of large properties reduced turnover, more emphasis on property management, and a bigger role for government. Much real estate activity would be as a result of geographic shifts in the population to the south and west and demographic shifts in the size of households, number of disabled, and other spcial housing needs. He exepcts the affordability gap to met by smaller units, higher densities, non-union labor, and more efficient city planning efforts.
- VI-B Graaskmap isn't sure risk ratios are appropriate except for solvency and capital payback since so many of the risks in real estate are shifted to others by contract. or modified by strategic positioning to protect against politcal exposure, channel demand, management intensive-ness, financial parameters, financing and tax matters and estate planning. Investors attempts to satisfy and as Peter Drucker points out improve the solvency position instead of the levergage position. Jaffe proposes a risk premium for risk adjusted discount rates, the certainty equivalent approach, senstiviety analysis, dicision trees and simulation.

BUSINESS 850

Lecture #1

- I. Real Estate investment is futuristic. Decisions move from irrational hope toward rationalized attitudes toward explicit intellectual strategies.
 - A. What is the time line of the hope?
 1. Pension fund vs. first time home buyer
 2. Columbia vs. rail yard
 - B. How topical are the attitudes?
 1. Investing against the tide--buy if everybody's selling
 2. Wait on tax shelter investments
 3. Life is a series of short runs so real estate investment context is a micro context.
 4. Real estate value is ultimately tried to future money markets and therefore investment is in a macro context.
 5. Real estate investment is passive and long-term; real estate development is exploitation of opportunity and arbitrage.
 - C. The essence of strategy for real estate is to improve spread by enhancing monopoly for marginal revenues while exploiting opportunities to reduce costs.
 1. Active investors create spread through opportunism at the micro level.
 2. Passive investors enhance spread through timing and arbitrage in the macro business cycle.
 - D. The essence of tactics is exploiting institutional and technical details in the appropriate time frame to achieve monopoly and spread.
 - E. The relationship of real estate enterprise to land and the creative urge to give form to tangible artifacts creates a huge emotional vector in real estate investment which means that the rational efficiency of capital markets is always distorted by adjustments for psychic income and loss to a greater degree than other capital intensive undertakings.
- II. First readings are suggestions of futurism on energy, political/social trends, capitalism, and business organization.
 - A. The second set of readings are more specific about attitudes and expectations about real estate.
 - B. The third set of readings are concerned with the intellectualism of measuring rates of return. Put those into context in terms of hope, attitude, strategy and tactical decision-making. Financial sophistication is possible at the tactical level.
 - C. The above perspective is necessary to understand or to discount the relative importance of income tax matters, or syndicators or other topical, or tactical matters relative to the ability to analyze at an appropriate level of abstraction, time dimension, and strategic orientation.
- III. Economic scenarios as opposed to probability analysis

Scenario I: THE POPULAR CHOICE

- Smooth transition to new economic base
- Steady economic growth with brief and mild slow-downs
- Gradually declining unemployment in traditional industries
- Growth solves the deficit and debt problems
- Real interest rates steadily moderate

Scenario II: ERRATIC TRANSITION

- Transition to new economic base interrupted by recessions comparable to those in the mid-1970's and early 1980's
- Economic growth erratic with strong spurts interrupted by stagnation or negative growth
- Aggregate unemployment remains in 7 to 12% region, with continued pockets of unemployment in excess of 15% in traditional industries
- Debt loads remain high with considerable default and rescheduling to protect credibility of financial institutions
- Pressures to control government deficits force continued increases in tax rates and increasingly severe spending adjustments
- Real interest rates moderate very gradually as deflationary forces from excess capacity decline slowly and debt loads keep pressure on borrowing

Scenario III: ECONOMIC DISTURPTIONS

Economic transition interrupted by disruptive breakdown characterized by:

- Significant defaults on foreign and/or domestic loans
- Runaway government deficits and drastic deficit-control measures
- Period of rising unemployment, concentrated particularly in traditional industries but spreading to other industries as well; aggregate unemployment reaches levels higher than in early 1980's
- Real interest rates remain high for most of the 1980's

Forms of Ownership

- I. A straight real estate mortgage loan is a form of real estate investment, the preferred form of investment if you want monopoly and spread without the risks of operating responsibilities
 - A. For the first 75 years, the 20th century, life insurance companies, wealthy individuals and a few public or semi-private corporations had a monopoly in lending on investment quality real estate.
 - B. Financial institutions were guaranteed a spread by Regulation Q
 - C. Basic loan form presumes safety of principle, reasonable yield, constant purchasing power and repayment from income.
 - D. More recently, institutions are concerned with conservation of buying power of principle, after tax equivalent income, optional liquidity and repayment from resale
 - E. The shift in investment philosophy reflected a loss of monopoly of capital implied by the general account and reflected in the need to justify performance in a segregated account, which was more similar to a demand account than a long term commitment. This shift meant :
 1. Yield at the expense of greater risk.
 2. Expansion of fiduciary roles
 3. Portfolio theory as a defense against poor performance
 4. Greater emphasis of tax exempt equivalency
 5. Greater emphasis on positioning against unanticipated inflation
 6. Greater recognition on role and compensation of venture capital.
- II. As a result the form of real estate ownership has become a hybrid of contracts which permit a negotiated balance of investment attributes among sources of capital where different investment priorities control.
 - A. True equity ownership is characterized by the degree of power and the selection of and rearrangement of capital components in the project.
 - B. Ultimately, the real owners as compared to the capital investors are those who enjoy the operating revenues of managing the project currently with participation in the value added by their performance, the conversion of human capital to financial capital.
 - C. The investment issues which have to be addressed to ownership are the degree to which the following are desired:
 1. Preference as to income and assets on the down side or greater share of income and capital on the up side.
 2. Greater control through full ownership or the capital recovery mechanisms available to the preferred creditor.

3. Degree of project control versus degree of responsibility for cost overruns and non-performance.
 4. Exposure to public liability
 5. Exposure to the income tax.
 6. Exposure to liabilities inherent in the securities laws.
 7. Profit centers to be obtained from expertise versus capital and market position.
- III. Alternative investors bring different forms of equity to the investor in exchange for a capital account, recognized with a stock share or simply a T-account in the equity ledger which reduces to a common denominator of capital equivalence a variety of things;
- A. Land
 - B. Credit rating
 - C. Control of market
 - D. Equity cash or seed money
 - E. Development expertise
 - F. Access to political subsidies and entitlements
 - G. Management services
 - H. Opportunity to arbitrage timing and foreign exchange or tax bracket shelters
- IV. When real estate investment is narrowed to consider only to the amount of capital required at a given price to make a project financially viable, then the ownership structure is intended to reduce the downpayment, reduce the loan constant and increase the spread, and generally reduce the investment by any single individual.
- A. Reduce the down payment
 1. High loan-to-value ratios with basket clause notes
 2. Land contracts
 3. Secondary refinancing
 - Second mortgages and wrap arounds
 4. Dividing responsibility between landlord and tenant financing
 5. Land leasing and sale and lease backs
 6. Government guaranteed high ratio loans
 7. Direct government price reductions through land write downs
 - B. Reduction of mortgage loan constant
 1. Stretch out payments
 2. Reduce base interest and replace with contingent interest
 3. Eliminate amortization with interest-only loans, lease backs
 4. Subsidized interest with tax exempt capital from government
 - C. Reduce investment by any single individual
 1. Co-op or condominium
 2. Partnerships - limited or general
 3. Real estate trusts - mortgage or equity
 4. Loan participations
 5. Real estate corporation
 - D. Real estate shares converts real estate finance to security status

- V. The format of the equity investors capital account gives the name to the real estate equity investment and reflects the number of persons to be reached, the scale of the capital pool, and the flexibility which may be desired in altering returns in order to reflect the significance of contribution as well as acceptance of risk; the spectrum might include:
- A. The triple net land lease
 - B. The convertible mortgage
 - C. Participating mortgage
 - D. The bond with warrants
 - E. The limited partnership unit
 - F. A joint venture unit
 - G. A real estate trust unit
 - H. A sub-chapter S corporate shares
 - I. A straight corporation
 - J. A joint venture of corporations with different levels of interest and voting power
 - K. Public industrial development corporation

Limited Partnership Constraints

- I. It's not what you sell but how you sell it that represents a major risk for syndicators.

- A. Private remedies include:

1. Section 12 (1) anyone who sells or offers securities in violation of registration and prospectus requirements has absolute liability to a purchaser for a decision and damages except for authorized exempt transactions.
2. Section 12 (2) gives rights of decision and damages against those who offer or sell by prospectus or by oral communication containing materially untrue statements.
3. Section 11 gives damages to those where registration statements contained untrue statements or omissions. Persons are liable include issuer, those who sign registration statements including appraisers and accountants, directors, general partners, experts, and underwriters who must prove due diligence.
4. Section 15 imposes contingent liabilities on those who control the persons liable for Sections 11 and 12.
5. Section 17a prohibits fraud and gives a private remedy to purchasers and applies to exempt securities and exemptions.
6. Rule 10b-5 implies private right of action for sins of omission and commission.

- B. Limitation period

1. Section 12(1) one year after violation but no more than 3 years after the offering.
2. Section 11 and 12 one year after discovery and no more than 3 years after sale
3. Given the poor economics of many projects, many investors could be considered defrauded except that courts are receptive to syndicators argument that damages should be reduced by tax benefits received.
4. The SEC can seek injunctions and criminal penalties for specific violations.
5. Burden of proof is on the plaintiff while the defendant has the burden of defending exemption from registration or application of statutory defenses.
6. Syndicators pursue two relevant exemptions - the private offering exemption under Section 4(2) of the 1933 Securities Act and and intrastate exemptions - sometimes called Regulation D.

- C. The private offering exemption initially included issuers such as banks, private placements for institutions, and business promotions by the founders.

1. 25-35 investors is a guideline but not determinent.
2. General solicitation rather than private
3. Informed investors
4. Security must come to rest with buyers who are not permitted to distribute to a larger group and anyone who purchases with the covert intent to redistribute becomes an underwriter without protection of exemption.
5. Integration is carefully controlled and discouraged to prevent fragmentation of an offer.

II. The Benefits of Regulation D in Squirming to Rescue Real Estate From Security Status

Went into force March 1982 - including rules 501- 506 which creates a three-tier structure of exemptions without registration.

A. The 3 tiers are:

1. Offerings involving sales up to \$500,000 - Rule 503
2. Offerings involving sales up to \$5 million to a limited number of "Big Hitters" or accredited investors (Rule 505)
3. Offerings to an unlimited amount of securities to a limited number of suitable persons, (Rule 506)

B. The magic number of sales is now 35 to non-accredited investors but offers and sales to an unlimited number of accredited investors. There is no reasonable inquiry requirement of issuers who do not have to determine investors are in fact accredited.

1. Banks, insurance companies, investments companies, employee benefit plans, officers, directors, and general partners are all presumed accredited.
2. Those who purchase \$150,000 minimum which is no more than 20% of their net worth or joint net worth, is presumed accredited.
3. Anyone with a \$1 million net worth INCLUSIVE of home, furnishings, and automobiles.
4. Any natural person with adjusted gross income in excess of \$200,000 in the past 2 years and in the coming year.
5. Tax exempt organizations with assets in excess of \$5 million
6. Private development and venture capital companies

C. Offerings and compliance with Regulation D do not register with the SEC but may have to register in a state.

Many states are amending their rules to match those of the SEC to avoid the hassle of supervising real estate deals.

- D. The intrastate state exemption limits the issuer, offerees, purchasers, or purchasers in resale to the same state of residence.

Problems With Limited Partnerships

- I. State and Federal regulations require full disclosure but prohibit very little activity explicitly. Presumably the fully informed investor can protect himself.
 - A. Each prospectus needs a definition of suitability standard, namely what type of income tax bracket, earned income position, net worth must be specified as a condition of subscription.
 - B. Failure to invest at least 50-60% of the assets of the program within 90 days of release of the funds from escrow exposes partnership to the need to register under the Investment Company Act. The SEC does not grant letters of exemption so this surprise may come home to roost only in the future.
 - C. All general partners are expected to operate with the good faith required a fiduciary, nevertheless, conflict of interest is to be expected and need only be disclosed, not avoided. These conflicts are often related to the forms of compensation and fees available indirectly to the general partner and sponsor of a limited partnership.
 1. The general partner is a general partner or an affiliate of the general partner in other limited partnerships (public and/or private) dealing in similar investments.
 2. The general partner has the power to (and does) invest the partnership's funds in other limited partnerships in which the general partner or an affiliate is the general partner.
 3. Properties are bought from or sold to affiliates.
 4. Affiliates who act as underwriters, real estate brokers, managers, etc., for the partnership act in such capacities for affiliated partnerships (or other affiliated entities).
 5. The same counsel represents both the partnership and the general partner.
 6. The general partner or an affiliate is hired by the partnership to manage the properties purchased, receiving sizable compensation.
 7. An affiliate of the general partner acts as the underwriter for the offering, receiving underwriting compensation.
 8. An affiliate of the general partner is a real estate broker, receiving commissions for sales of the partnership's property.
 9. An affiliate of the general partner is a real estate broker, receiving funder's fees for purchases of property for the partnership.
 10. The law firm with which the general partner is affiliated renders opinions and drafts partnership documents and receives legal fees.
 11. An affiliate of the general partner acts as an insurance agent for properties acquired by the partnership, receiving compensation.
 12. An affiliate of the general partner acts as the accountant and administrator for the partnership, receiving payment from the partnership for such services.
 13. An affiliate of the general partner places mortgages for the partnership or otherwise acts as a finance broker, receiving commissions for such services.

11. The maximum dollar amount of all compensation, including repayment of out-of-pocket expense, to be paid the general partners, underwriters, and any and all possible affiliates must be tabulated. A review of these lists is always instructive as to the profit centers inherent in the organization and control of the real estate venture. Some common compensation centers include:

- A. Fees and disbursements incident to the purchase and sale of the limited partnership interests; such fees include not only those paid to underwriters and sales personnel but also consist of fees of counsel, accountants, and other professional experts, etc., involved in the implementation of the program;
- B. Fees payable for services rendered in acquiring properties on behalf of the partnership;
- C. Fees payable to the general partner or to unrelated parties for arranging mortgage financing on the properties for the benefit of the partnership;
- D. Fees payable to the general partner or to unrelated parties for refinancing mortgage indebtedness at some point during the period of ownership (in some cases, a sharing of refinancing benefits, in lieu of a fee, to the general partner);
- E. Fees payable to the general partner for continuing supervision and administration of the partnership and/or its properties;
- F. Fees payable to the general partner or to unrelated parties for the sale of one or more properties owned by the partnership;
- G. Participation by the general partner in cash flow or residuals arising out of the operation, refinancing, or sales of properties;
- H. Fees payable to the general partner or to unrelated parties for marketing or for services rendered in "renting-up the properties";
- I. Annual fees payable to the general partner or unrelated parties for services rendered in the management of the properties;
- J. Fees or builder's profits, overhead absorption, and/or land write-ups; and
- K. Investments purchased or to be purchased for the program from the sponsor or its affiliates.

SUMMARY OF WISCONSIN LIMITED PARTNERSHIP LAW
(Chapter 179, Wisconsin Stats)

A. In order to form a limited partnership under Wisconsin law, all persons desiring to form the partnership shall sign and swear to a certificate of limited partnership. There must be no less than two persons, one, the general partner and one the limited partner.

1. The certificate must be filed with the register of deeds in the county in which the partnership's principal place of business is located (Wisconsin Stats 179.02 (2))
2. Thus, county records become an excellent prospecting device to identify who in the county is investing in local limited partnerships.
3. If additional partnerships are sold an amended certificate must be filed - thus maintaining constructive notice of the relative responsibilities of investors associated with the project.

B. The certificate must contain the following information (also useful for market intelligence):

1. Name of partnership.
2. Character of business.
3. Location of principal place of business.
4. Name and residence of every general and limited partner.
5. Term of partnership.
6. Cash and description of other property contributed.
7. Terms of further contributions obligated to be made.
8. Time that contribution of limited partner is to be returned, if agreed upon.
9. Terms of profit distribution.
10. Terms of substitution by the limited partner of an assignee, if agreed to.
11. The right to admit future limited partners, if agreed to.
12. Terms of priority to contributions or compensation among limited partners.
13. Terms of the continuation of the partnership in the event of the deaths general partner by remaining general partners, if agreed to.
14. The right of the limited partner to receive property other than costs, if agreed to.

Wisconsin Stats 179.02(a)

C. Wisconsin Stats 179.24(2) sets forth ten situations when the certificate of limited partnership shall be amended. These ten situations involve a change in either the partnership, the partners, or the financial relationship between the partners. Wisconsin Stats 179.25(5) requires that the certificate's amendment be filed with the register of deeds.

I. WHAT IS A DEVELOPMENT

A. Elements Common to All Developments

1. Feasibility study
2. Land acquisition
3. Architectural design
4. Zoning variance and code compliance
5. Financing/construction and permanent
6. Construction
7. Rental or sale

B. Complexity of Development

1. Most simple - Private home subdivision (gestation period - two years)
2. Middle range - Single high rise structure in urban core on land owned by single private developer and conventionally financed. Latest variation - Institutional lender as equity partner (gestation period - three to five years)
3. Most complex - Multiple, mixed-use structures to be constructed by multiple private developers on land owned by one or more government entities in deteriorated urban core, in partnership with one or more levels of government (gestation period - up to ten years or more)
 - a. quasi public entities such as academic institutions or missions
 - b. advantages and disadvantages unique to Public-Private developments
 - c. cutting edge merits closer analysis

* Based on a lecture by Robert H. Freilich. Mr. Freilich is the Hulen Professor of Law, The University of Missouri-Kansas City School of Law. He is also President of Freilich, Leitner and Carlisle, P.C. in Kansas City, Missouri

II. THE PARTNERSHIP BETWEEN THE PUBLIC AND THE PRIVATE SECTORS

A. Evolution of Government Participation in Development

1. As ~~passive~~ enforcer of codes and ordinances with which private developer must comply
2. As stimulator of private development in the public interest by offering incentives in the form of site assemblage, writedowns, grants, low-interest financing and tax abatement programs
3. As developer of low-income housing "projects" on turn-key basis - leaving more lucrative and creative commercial development to private sector
4. As initiator of lucrative commercial development by contract, with private developers in order to renew urban core and create employment opportunities
5. As partner of private developers - viewing development as profit center to seed future development
 - a. civil service mentality vs. entrepreneur
 - b. corporation counsel vs. outside counsel

B. Government's Contribution As Partner

1. Assemblage of site
 - a. government owned property
 - (i) underutilized or obsolete government property (e.g. schools, military bases, police stations)
 - (ii) in rem property
 - (iii) previously condemned urban renewal sites
 - (iv) air rights
 - b. create new property (e.g, landfill)
 - c. eminent domain
2. Relaxation of zoning and building codes and overriding administrative delay
 - a. The zoning game

- b. TDRs, bonus systems
 - c. Fast-track permitting
- 3. Low cost financing
 - a. tax exempt financing
 - (i) revenue bonds
 - (ii) tax increment bonds
 - (iii) mortgage backed bonds
 - b. sale-lease back
 - c. lease and loan guarantees
 - d. Federal grants (e.g., EDA, UDAG, UMTA)
- 4. Property tax exemption (or flexibility of payment)
 - a. real estate taxes
 - b. sales taxes (ownership for exemption purposes vs. ownership for tax basis purposes)
 - c. recoupment as payments in lieu of taxes (PILOT) or payments in lieu of sales taxes (PILOST)
- 5. Construction of infrastructure (e.g., utilities, schools, parks, parking, transportation)
- 6. Clout through comity with other levels of Government
 - a. ability to expedite by log rolling or special legislation
 - b. competition between levels of government (management by committee)
 - c. lending aura of respectability

C. Private developer's contribution to partnership

1. Risk capital
2. Practical experience
3. Expertise (particularly in economics)
4. Imagination
5. Energy
6. Optimism
7. Guts

D. Competing objectives of governments and private developers

1. Objectives of Governments
 - a. revitalize depressed or deteriorated urban area
 - b. increase tax base
 - c. create amenities (e.g., schools, power stations, sewage facilities, roads, parks and balance of infrastructure)
 - d. create employment and orderly economic growth
 - e. timely commencement and completion of project
 - f. creating hallmark of current administration -- public monument of aesthetic merit, without regard to economics
 - g. minimize adverse effect on environment
 - h. eliminate likelihood of pitting government against small tenants (e.g., condominium on leasehold) and other special interest groups
 - i. avoidance of conflict of interest and sunshine law issues
 - j. ensure compliance with comprehensive plan, master lease, enabling legislation and bond resolution

- k. affirmative action
- l. create profit center to seed future development
- 2. Objectives of Private Developer
 - a. obtain and keep designation as partner/developer
 - b. negotiate deal that yields maximum return on investment
 - c. satisfy requirements of private institutional lenders and investors

III. STRATEGIES AND TACTICS TO ACHIEVE OBJECTIVES OF BOTH PARTNERS

A. Legal Format and Documentation

1. Setting the deal among government entities (no one structure)
 - a. who will play lead role?
 - b. legislation
 - c. project agreement
 - d. master lease
2. Assemblage of site (through condemnation or otherwise)
3. Transfer of title (sale or lease)
4. Raise monies for acquisition and infrastructure
 - a. bond issue
 - b. government budget allocation
 - c. developer exactions
5. Design guidelines
6. Environmental impact study
7. Requests for proposals (RFP)
8. Proposals from private developers
9. Conditional designations
10. Construction agreements (for construction of infrastructure)
11. Sales vs. leases to private developers
 - a. ability to finance
 - b. ability to police
 - c. ability to share profits
 - d. ultimate ownership

12. Mapping agreement (utility company/City services)
13. Master development agreement
- B. Getting the designation - and keeping it
 1. Public bidding requirements
 2. RFP (a hybrid form)
 - a. prior political procedure
 - b. increased developer's ante
 - (i) formal marketing study
 - (ii) architectural plans and models
 - (iii) formal presentation
 - c. factors to be considered in making designation
 - (i) aesthetic merit
 - (ii) reputation of developer
 - (iii) credit worthiness of developer
 - (iv) affirmative action
 - (v) economic benefits to government
 - d. forging alliances between competing developers
 3. Conditional designation (a valuable option to conduct exclusive negotiations)
 4. Dedesignations - terminating the partnership
 - a. as a matter of law
 - b. as a practical matter
 - (i) timing
 - (ii) loss of momentum
 - (iii) political image
 5. Financing Commitments
 6. Increasing the price of the "option" by reason of
 - a. letters of credit
 - b. per diem charges
 - c. architectural plans

7. Assignment or transfer of designation by developer
8. Land banking
- C. Negotiating key clauses in a partnership agreement between government and private developer
 1. Rental payments
 - a. covering obligations to bond holders
 - b. Payments in lieu of taxes (PILOT)
 - (i) flexibility
 - (ii) difficulty in estimating if tied to actual taxes (separate tax lots, separate owners local government cooperation in assessment of tax exempt property)
 - (iii) difficulty in implementing abatement program
 - (iv) deductibility for income tax purposes by co-op owner
 - c. payment in lieu of sales tax (PILOST)
 - d. public facilities maintenance charge (difficulty) in estimating for purposes of developer's projections)
 - e. share of upside
 - (i) percentage of income stream
 - (ii) share of proceeds of mortgage refinancing
 - (iii) share of proceeds from sale including co-op or condo
 2. Segregation of in lieu of payments in trust for special purpose (avoid capture by bond resolution)
 3. Construction Clause
 - a. timine commencement
 - b. timely completion

- c. security for developers obligation
 - (i) personal guarantees
 - (ii) surety bond
 - (iii) letter of credit or other collateral
- d. quality control
 - (i) aesthetic judgments
 - (ii) exterior v. interior
 - (iii) construction schedule
- 4. Timely completion of infrastructures/remedies for default
 - a. rent abatement
 - b. consequential damage
 - c. each developer to build own infrastructure
 - d. one developer to build infrastructure for entire project
- 5. Conflicts among private developers
 - a. first on board
 - b. last on board
 - c. most favored nation clause
 - d. master developer agreement
- 6. Rigidity of master lease/bond resolution
 - a. as negotiating weapon
 - b. as bonafide impediment
 - c. difficulties in amending

D. Case Study

Business 350 - Limited Partnership Terminology

Definitions of "Return"

1. Taxable income,
2. Net profit only (i.e. not net loss),
3. Taxable income calculated on the basis of straight line depreciation,
4. Net profit calculated on the basis of straight line depreciation,
5. Cash available for distribution before allowance for reserves,
6. Cash available for distribution after allowance for reserves,
7. Cash actually distributed,
8. Cash available for distribution before allowance for reserves plus the amount of that year's principal payment on the mortgage debt,
9. Cash available for distribution after allowance for reserves plus the amount of that year's principal payment on the mortgage debt,
10. Cash actually distributed plus the amount of that year's principal payment on the mortgage debt,
11. Cash available for distribution before allowance for reserves plus the tax liability or the tax shelter benefits of the taxable income calculated for a specified tax bracket,
12. Cash available for distribution after allowance for reserves plus the tax liability or the tax shelter benefits of the taxable income calculated for a specified tax bracket,
13. Cash actually distributed plus the tax liability or the tax shelter benefits of the taxable income calculated for a specified tax bracket,
14. Cash available for distribution before allowance for reserves plus the tax liability or the tax shelter benefits of the taxable income calculated for a specified tax bracket plus the amount of that year's principal payment on the mortgage debt,
15. Cash available for distribution after allowance for reserves plus the tax liability or the tax shelter benefits of the taxable income calculated for a specified tax bracket plus the amount of that year's principal payment on the mortgage debt,
16. Cash actually distributed plus the tax liability or the tax shelter benefits of the taxable income calculated for a specified tax bracket, plus the amount of that year's principal payment on the mortgage debt.

Definitions of "Sales Proceeds"

1. Gross sales price,
2. Gross sales price less closing costs and real estate sales commissions, also known as the net sales price,
3. Net sales price less beginning mortgage balance,
4. Net sales price less mortgage balance at time of sale,
5. Net sales price less purchase price,
6. Net sales price less the mortgage balance at time of sale less the initial equity investment,
7. Net sales price less the mortgage balance at the time of sale less the initial equity investment plus the sum of returns, however defined, distributed to the limited partners,
8. Net sales price less the partners' basis for tax purposes (the purchase price less accumulated depreciation),
9. Net sales price less the partners' basis for tax purposes less the amount necessary to pay taxes at some specified rate,
10. All cash, after payment of mortgage balance at time of sale, including refund of working capital, unused reserves, and unallocated reserves.

Joint Ventures in Real Estate

- I. The term joint venture has been used to loosely to describe a variety of arrangements in American business which could be classified as partnerships. In its broadest sense a joint venture is an association of two or more persons to carry out a single business enterprise for profit, whatever the legal form of association.
 - A. The term grew out of the fact that in many states, prior to the uniform partnership act, corporations could not engage in partnerships so that a partnership of two corporations was called a joint venture. Since the UPA has eliminated that corporate restriction, the term today is preserved by corporate lawyers in the hope that it provides constructive notice to the public that one partner in a joint venture has limited authority to bind the others. It remains to be proven how much a word or phrase can do to defend a suit by a claimant against all partners claiming detrimental alliance on the credit of all for a transaction involving only the interests of one partner.
 - B. Joint ventures are primarily associated with but not limited to institutional money sources such as pension trustees and life insurance companies and therefore their peculiar problems of regulation will influence most discussion.
 - C. As these institutions have had a growing willingness to forego limit of liability and fixed return in pursuit of yield, the dominant characteristic of the joint venture has come to the fore. Limited partnerships provide a single tax entity with limited liability so long as there is not operational management by the limited partner. As soon as the money source wants participation in management while retaining a single tax entity it is necessary to go to a joint venture. As will be shown there will be considerable maneuvering to retain limited liability, often without success.
 - D. Thus the joint venture goes to the heart of the question of what is equity - the right to benefit or the right to control and clearly shows it is the right to control.
 - E. Finally institutional lenders who wish to make a mortgage and an equity commitment faced a legal problem under Section 13 of the UPA which on its face states no limited partner shall receive or hold as collateral any partnership property - although this may be referring to privileged claim on assets of insolvent partnership (Hughes vs. Dash).
- II. Joint ventures can take a variety of legal form to put different weight on issues related to control, limited liability, yield, tax impact, and continuity.
 - A. Where the association has equal controls you have a true joint venture; where the developer is essentially in control you have a limited partnership and participation loans and leases. Where the money venturer has control it will generally take some kind of corporate structure or continuity and segregation of assets.

- 2
- B. Most of the arguments in negotiation will center around provisions for:
1. Allocation of risk, profits, and limitations on liability
 2. Responsibility for contingent capital contributions
 3. Assignability of interests
 4. Conflict of interest
 5. Replacement of management due to incompetency, disability, bankruptcy or death of key people
- III. Selection of a form of venture entity will be heavily influenced by tax factors but there are many commonplace considerations as well. The following review of alternative forms of venturing can suggest these non-tax issues:
- A. Tenancy in Common - Simplest form of venture - T.I.C. reports for tax purposes his share of gross income less his share of expenses paid - true even if he pays more than his share - excess treated only as loan to other T.I.C. - generally suited only for passive investment - inherent title problems on death of T.I.C. - management problems - partition rights - liability problems.
- B. Corporation - Many Practical Advantages - Not title problems from death or divorce - flexibility in transferring interests - centralized management - limited liability - flexibility of profit allocations through use of various classes of stock.
- However, tax disadvantages - corporation is a separate tax entity - distributions doubly taxes - once in corporation, once as dividends - if corporation able to wipe out earnings by soft money deductions, in some states no distribution of cash possible - no pass through of soft money.
- C. Subchapter S - Since 1958 - Limited liability and pass through of losses - all tax advantages of partnership plus limited liability - can't be used in most real estate deals.

Requirements -

1. No more than ten stockholders
2. All of whom either individuals or estates
3. Only one class of stock
4. No more than 20% of gross receipts from rents - dividends - interest - unless venture involves subdivision or sale of condos, probably can't use.
5. Two unpublished rulings - if significant services involved.
 - a. Hotel or motel income not treated as rent.
 - b. Shopping center where landlord provided subst. services such as security, promotion, maintenance - income not treated as rent.

Query: How far can you carry these rulings - in any apartment house or office building there are similar services.

- D. Land Trusts - Advantages in central management - title holding - limited liability - not really true venture - real problem is the association problem - discuss later.
- E. Reit - Special kind of trust
 - 1. Large group of investors - at least 100.
 - 2. Not more than 50% of trust by any five.
 - 3. 90% of trust income from passive income, dividends, rents, interest, gains on sales of stock, real estate.
 - 4. 75% must be real estate income.
 - 5. Income must be passive, i.e., no management functions.
 - 6. 90% of ordinary income must be distributed.
- F. Partnership - great tax advantages - it is not a separate tax-paying entity, merely a conduit - soft money deductions pass through to partners - mortgage can be utilized as part of basis. Also - non-tax - title held in partnership name under UPA; profit allocations and priorities possible - management controls available - securities problems avoided under certain states Blue Sky Law.

Big disadvantage - liability; partner's own estate subject to partnership debts.

- G. Limited Partnership - limits liability of limited partner. To get limited liability, can't participate in management - even this is breaking down - in Calif., for example, limited partner can now vote on sale, removal of general partner or other basic matters to partnership structure, without losing limited liability status.
- IV. Tax advantages or objectives will also play a major part in the choice of form of the venture and contributions of investors to it. The developers tax incentive are usually subordinated to those of the investor/money partner.
- A. The investor should try to salvage soft money deductions during construction such as:
 - 1. Carrying charges during holding of property - interest and taxes - ground rent.
 - 2. Mortgage points.
 - 3. Prepaid management fee - promotional fees.
 - 4. These can be capitalized - Sec. 266 I.R.C. Institutional lender who participates after completion may try to negotiate for these to be capitalized.
(A deduction requires an expenditure so checks should be exchanged even where they wash out)
 - B. A separate corporate entity is a double tax entity, taxable at the corporate rate of 45% or more. On a big project tax losses may exceed the carry forward capacity to use them. Furthermore the effective tax rate on a mutual life insurance company may be as low as 15% so the marginal advantage is to a single tax entity, unlike an individual in a higher tax bracket.

General Partnership

Business Aid 850

- I. Accelerated marketing of limited partnership interests led to certain adverse results and responses.
 - A. Separation of construction and management from packaging function of financial team so that real estate interests were recognized as a security.
 - B. Recognition as a security meant that wholesale marketing of real estate interests became very expensive and time consuming; the expense was not justified by market value or earning capacity of investment.
 - C. Investment, therefore, was justified on soft dollar benefits of tax shelter and to maximize tax shelter, there were many abuses of accounting for IRS, which led to restrictions in tax administration and tax codes.
 - D. Abuses of investment bankers and local promoters created many bad investments due to absentee ownership, amateur investors, and excessive leveraging.
- II. The general partnership will avoid many of these pitfalls while retaining single conduit tax status.
 - A. Limited number of partners in a venture contribute significant amounts of cash ~~in order that~~ so that direct and personal involvement is probable and logical.
 - B. General partners designate one partner as managing partner and, therefore, should insist on a proven track record, substantial net worth, and an organization which can survive the loss of key people.
 - C. To prove the existence of a general partnership, there must be proof of regular meetings and input by the general partners, so there is no centralized management by default.
 - D. The security laws do not apply to the search for partners in the capital venture. Thus, it is far easier to prepare financial statements or document describing the project without committing a sin of omission or commission.
- III. The general partnership agreement would contain the following types of provision.
 - A. Name of partnership
 - B. Duration is established not to exceed a specified date, which may reflect length of mortgage, duration of subsidy, land lease terms or whatever.
 - C. Names and addresses of all general partners and their percent of interest.
 - D. The capital contribution generally distinguishes between contribution of the managing partner which may include site, plans, and fees, etc. However, a general partner should typically start at the very beginning on

a venture, so that all checks are drawn on the partnership. With the organization of a partnership, the managing partner can generally borrow working capital at the bank in the name of the partnership.

1. Note the managing partner is not limited by the Safe Harbor Rule.
2. Note the managing partner does not have to fund the project until loan commitments are received and project bid in order to provide an acceptable level of certainty to a limited partnership perspective.
3. For organization of the partnership, the managing partner typically receives 5 or 10 percent partnership position.

The general partners put in a prorata share of a specified dollar amount of capital, representing 90-95% of partnership interest. Partners may set up a series of payment dates over 2 - 5 years, depending on the lead time and cash requirement cycle of the project. If any partner is delinquent, the majority of remaining partners may expel the delinquent partner without dissolving the partnership. If the delinquent partner has paid less than 10%, of his agreed capital contribution, it is forfeited. If greater, the partnership will be appraised and the remaining partners or any new partner will have five years to amortize expelled partner share ~~f~~ value at 7% per year.

- E. The purpose of the partnership must be limited to specific project types on specific sites.
- F. Contract for construction will include performance and completion bonds for the total amount of construction and secured credit financing is generally tied to a certain source and term, but not to an interest rate. Each partner agrees to provide personal statements and other documents to secure mortgage credit and agrees to personally guarantee the development and construction loan while explicitly avoiding any liability for permanent mortgage loan.
- G. Managing partner receives a specified development fee in lieu of any or all other charges or personnel and resources. Moreover, the managing partner agrees to fund operating deficits, etc. for the initial rent up stage to the degree that loans and equity capital are not adequate. The agreement also provides that the partners may select their own property manager and that the managing partner can be considered so long as he charges no more than that charged by competitors in the area. Finally, the managing partner is compensated a specified amount for management of the partnership, payable monthly. Extraordinary accounting or legal services may be separately charged. No partner may be compensated for anything else unless approved by the vote of the partners.
- H. A meeting of partners is required no less than every quarter and a special meeting may be called by the managing partner or any partners representing 20% of shares with 5 days ~~f~~ written notice. A vote must represent at least ~~50%~~ 51% of interest entitled to vote or there must be unanimous written consent.
- I. Partnership books will be closed on December 31st and audited each year by an accounting firm selected by the partners.

- J. Agreements are filed in both the county organization and the county's in which projects are located.
- K. Partnership may be dissolved or re-financed at any time.
- L. No partner may sell a sign, or hypothecate, his partnership interest or any sub-interest without consent of partnership and the mortgage lender.
- M. Partnership is continued unless a partner owning 50% or more of the partnership dies, becomes legally incompetent, or a judged bankrupt. Surviving partners have option to purchase deceased partner's share or a voting to accept a new partner. Where partnership laws prevent it, the surviving partners have the right to immediatly reorganize the partnership subject to the agreement and amendments there to, in effect at the time of loss of the partner. Surviving partners must give written notice of intention to purchase within 30 days of the contingency. Purchase price will be the prorata share of book value of the partnership adjusted to recognize real estate at fair market value. Each survivor has the option to purchase his proportionate interest relative to the other survivors. Each partner agrees to a 6 year installment purchaser with interest rate at 1% over prime. Buyer provides a promisory note and collateral assignment of partnership interest. If partners do not buy out the selling partner, the partnership is immediately dissolved.
- N. Appraisal of the project must be by an MAI who ~~4~~ has done business in the state and counties where property is located for not less than 5 years, and if necessary, they may employ the same appraisal arbritration process used in fire insurance.
- O. Insurance has to be maintained for fire and extended coverage at 100% of replacement cost, and public liability maintained for 2 million dollars. Other types of insurance including loss of rental income is left to custom for similar properties, and partnership is obliged to rebuild.
- P. Legal documents must be executed by 2 partners, the managing partner and one more authorized by all of the partners.

Q.

IV. Analysis of financial statements.

SELF DEALING WITH PARTNERSHIPS

- I. Unlike corporations where the corporate entity is clearly distinct from the individual investors, the partnership is a little fuzzy as to when the partner is dealing with an entity and when he is dealing with himself. Section 707 of the 1954 Code established the entity concept as the general rule:
 - A. Established the general rule that partners engaged in transactions with their partnership, other than in their capacity as partners, shall, with exceptions, be considered as acting as non-partners.
 - B. Provided two specific exceptions to the general non-partner rule which govern certain sales or exchanges of property between partners and their controlled partnership, as well as between two controlled partnerships, and
 3. Provided that "guaranteed payments" to partners for services or for the use of capital, if determined without regard to partnership income, be accorded the entity treatment for purposes of partners' gross income and the partnership's trade or business deductions.
 - D. Nevertheless, the IRS under Section 482 has the right to allocate income and deductions among two or more taxpayers, organizations, etc. to prevent evasion of taxes or to clearly reflect income so that substance of a transaction governs over form.
- II. The exceptions have to do with losses on the direct or indirect sale or exchange of property between partnership and partner when the partner owns directly or indirectly more than a 50% interest in the partnerships capital or profit. Ownership may also be modified by allocation of management control.
 - A. Sales and exchanges are an area of exception.
 - B. Sale and leaseback transactions between partners and their partnership is another area looked at closely by the IRS if the sales price or the rental payments seem low.
 1. The IRS may contend that the purchaser-lessor has received advanced rental income to the extent that any spread between fair market value of the income and its purchase price .
 2. Or if the actual rental is less than fair rental value, the defference is additional consideration to the seller, or the seller has retained an equitable interest to which a portion of the property basis must be allocated.

LIMITED PARTNERSHIP

- I. Since the limited partnership has central management and limited liability by the nature of its organization, it is important to eliminate marketability of shares and continuity to avoid taxation as a corporation. As a result the investment is very illiquid and subject to some unfortunately tax traps if it dissolves before the end of its stated venture time. Therefore, the prospective limited partner must ask himself how he withdraws from a limited partnership.
 - A. A limited partnership interest which becomes burdensome is obviously one that has a problem, probably that the market value of the asset would not generate enough cash to pay the recapture tax. Until the tax law reform there were a number of options:
 1. Die and allow the estate to achieve a new basis, i.e., zero
 2. Declare bankruptcy in which case you wouldn't have to pay the tax on the gain.
 3. Commit tax fraud by not reporting the transaction
 4. Purchase tax shelter in the wife's name, file a joint return, and when the tax shelter is exhausted and the investment became a burden, divorce the wife.
 5. The last alternative is dangerous in the community property state.
 - B. The practical answer has been to select only investments that have sufficient viability to survive the client and be valuable to the heirs. However, some clients wish to simplify their financial lives as they advance in years.
 - C. All of the above are generally unattractive alternatives. Recently the attorneys have decided there is no legal reason under the Uniform Partnership Act there is no legal reason why you cannot just walk away from a partnership. Just notify the other partners you are withdrawing. As there is a doctrine under partnership law (known as *delectus personarum*) which means you cannot force a person to be a partner against his will or to accept a third party as a partner. The restriction on transferability refers to the latter.
 - D. A contractual restriction against withdrawal would mean the withdrawing partner would be subject to damages but in most cases, how could there be an injury?
 - E. If a limited partner abandoned his interest, the remaining partners pick up a pro rata share, the exposure of the withdrawing partner would be for assessments or for previous distributions for capital. Any tax free distribution, one of the goals of tax shelter investment, would be deemed distribution of capital which sometimes can be at the expense of third parties unable to collect their claims.
 1. For example, a subsidized housing project might make cash distributions of 4% each year so after 10 years you have 40% of your capital contribution back in cash.
 2. To the degree that the abandoning partner has a negative capital account he would pay taxes on the withdrawal.

3. If the only limited partner withdrew, the partnership would terminate and the property would be owned by the remaining partner by a defacto distribution. The only penalty would be loss of first user status for accelerated depreciation
 4. To abandon the partner must notify the general partner to file an amended certificate of partnership.
- F. Some people believe you can give a poor partnership share to a university or other charity. However, if the charity uses borrowed money to invest, it is taxed on unrelated business income in proportion to the loan ratio. A charity can only use straight line depreciation. The other partners must accept the charity, under the rules of transferrable shares.
- G. There is a possibility of negative basis interest to a personal holding company as part of a plot in which you put positive and negative interests so that investments which have not reached the cross-over point will cover those that have. Under Section 357 you would be taxed to the extent that liability exceeded basis.

BUSINESS 850

REMICs, REITs, AND MORTGAGE BACKED BONDS

- I. By the mid-1970's, there was great fear that traditional mortgage investment intermediaries would be unable to supply enough capital for the inflationary purchase prices of homes and commercial building. Not only had inflation greatly increased the total dollars required, but the interest rates had soared at the same time that there were all kinds of negative incentives to saving money in fixed dollar instruments.

A. Garn-St. Germain Depository Institutions Act of 1982.

1. Adjustable rate mortgages.
2. Expansion of non-residential real estate loans for THRIFTS from 20-40 percent of assets.
3. Power to accept demand deposit.

B. To provide liquidity to meet commercial and corporate demand deposits, the 98th Congress created the first comprehensive legislation on secondary markets called The Secondary Mortgage Market Enhancement Act of 1984. However, it fell short of what had been recommended by the President's Commission on Housing.

1. Preempted state investment and security laws relative to mortgage backed securities.
2. Permitted forward trading without registration on conventional mortgage securities with private guarantees.
3. Federal Preemption reduced issuing costs and broadened investment eligibility to state-regulated institutions and state pension funds.

C. Significant barriers remain relative to pre-payment calls.

1. Mortgage backed security were required to use the grantor trust with passive management to prevent a double layer of taxation.
2. Sears/Dean Witter tried to expand the ability of the trust by expanding the range of pay-back options and which also permitted the issuer to count the transaction as a sale of assets so that mortgage bankers could be a source of mortgages. --FASB had ruled that CMO's were debt financing--killing the CMO as an outlet for mortgage bankers.
3. IRS reacted in 48 hours, grandfathering the Sear's issue, but defining future multi-class structurings as an association taxable as a corporation at the pool and the investor level. In short, any shift of interest among classes in the underlying pool violated the nature of a grantor trust. The IRS did not flinch despite strong political resistance and promised detailed rules later in 1985.

- D. The 1982 Commission on Housing had proposed either using limited partnership as a vehicle or a TIM--trust for investment in mortgages. TIM's would retain tax exemption while allowing the issuer to manage the cash flow for call protection and alternative payment streams on principle.
- E. Other impediments were inherent in the securities law.
 - 1. Dispute as to whether accredited investors rule was useful or whether legislative exemption from the securities act was needed.
 - 2. Bank of America Case (EPIC failure) discouraged Congress from exemption of the anti-fraud registration process.
 - 3. Many wanted a rating agency to establish investment grade ratings.
 - 4. Since mortgages historically have not been regarded as serious investment assets, most ratings would be with a third-party credit enhancement.
 - 5. Negative historic reputation of single family mortgages is even worse relative to multi-family and commercial mortgages.
- F. Positive public policy benefits of easy access to traditional financial markets include:
 - 1. Equalized geographic access to capital;
 - 2. Investor response to market conditions despite traditional illiquidity;
 - 3. A rational access to capital pools outside of traditional intermediaries;
 - 4. Permits replenishment of cash for primary lending institutions;
 - 5. Consumers enjoy more credit at lower interest costs;
 - 6. Safety of diversification;
 - 7. Better yield with the spread over treasuries;
 - 8. Liquidity and flexibility; and
 - 9. Secondary markets also exist for auto loans, student loans, subsidized mortgages.
- II. The Tax Reform Act of 1986 created the Real Estate Mortgage Investment Conduit--REMIC--to avoid double taxation and to encourage more efficient financing of mortgages pools. In short, a REMIC permits:
 - A. REMIC allows multiple-class mortgage pass-throughs that will not be taxed as separate taxable entities.
 - B. REMIC enables senior/subordinated mortgage securities with no restriction on trading the subordinated interests.
 - C. REMIC allows CMOs with no issuer's equity interest. Under prior regulations, issuers had to retain an interest for favorable tax treatment.
 - D. REMIC allows pass-through pools to maintain cash reserve funds for added credit enhancement.
 - E. REMIC enables thrifts and others with discount mortgages to transfer

- E. cont. them and recognize tax losses while treating the transaction as a financing for accounting purposes and avoiding unwanted accounting losses.
- F. REMIC reduces "phantom income" on discount securities by interpreting how the original issue discount rules are applied to debt with uncertain maturities.
- G. REMIC elections avoid withholding tax on interest paid to foreign investors, even on mortgages originated before July 19, 1984.
- H. REMIC allows for cash-flow efficiency (i.e., authorizes monthly pay instruments to match monthly pay collateral which reduces reinvestment risk created by quarterly pay instruments).
- I. REMICs composed of residential mortgages are qualified investments for Savings and Loans. REMICs are also qualifying investments for REITs and pension funds.

FEDERAL INCOME TAX NOTES

I. As proposed earlier, every tax question should be approached systematically since nobody is going to remember details of the code.

A. Tax results of a sale or exchange should trigger these questions:

1. What is the amount realized on the sale?
2. How much is the gain or loss?
3. Will the capital gain and loss provisions apply?
4. When is the gain or loss on the transaction recognized, when must it be included in gross income?

B. These questions can be applied to the following categories:

1. Sale or exchange of personal residence
2. Involuntary conversions
3. Installment sales
4. Deferred payments sales
5. Contingent price sales
6. Tax deferred exchanges
7. Farm sales

C. The gain or loss from a sale is measured by the difference between the amount realized and the adjusted basis of the property disposed of (CCH 902)

1. The net amount realized is the value of everything received reduced by any cost incurred making the transfer, such as legal fees, commission, advertising costs and qualified expenses of fixing up the property to sell it (within 90 days of sale paid 30 days thereafter, not otherwise deductible and not a permanent improvement).

2. The adjusted basis is developed extensively in CCH 934 and 935.

D. The concept of taxable profit is useful to understand twists in the tax law. (CCH 901) The taxable profit on a sale or an exchange is the excess of the net cash, or fair market value of other property, received for the property sold or exchanged over the cost or other basis of the property sold or exchanged, adjusting that basis by adding to it any capital expenditures of the seller while he held the property and deducting any depreciation or depletion and other capital recoveries.

II. Sale of personal residence is a unique aspect of the tax law and estimated to be the single largest tax loop-hole, perhaps costing the Feds 2 billion or more.

A. Two special tax benefits for a tax payer who sells personal residence:

1. For those 65 years of age a one-time exclusion of the first \$35,000 of adjusted sales price if they have lived there at least five years of the preceding eight. Adjusted sales price not exceeding \$35,000, entire gain excludable. Otherwise the ratio \$35,000 to adjusted sales price X the gain.

2. Sale of a principal residence followed by purchase within 18 months or construction two years after the sale is exempt so long as purchase price exceeds adjusted sales price of old residence.
 3. Review examples in CCH 903.
- B. Sale of low-income housing projects subsidized by the Federal Government to the tenants or to a non-profit organization representing the tenants may also permit deferral of all or part of the gain.
1. To defer the gain the seller of the project must acquire, build, or renovate another qualified low-income project.
 2. Gain is recognized to the degree that adjusted sales price exceeds cost of the replacement.
 3. The basis of the replacement property is reduced by the amount of gain realized but not recognized.
- III. Involuntary conversion is a short circuiting of the asset cycle to cash due to condemnation, an insured casualty loss, or an uninsured loss. CCH 907
- A. The taxpayer has an interesting decision or option to make in his treatment of involuntary proceeds.
1. There is no gain if he replaces the property in an amount equal to the loss, but his basis remains as before so that the new expenditures do not create new depreciation base. Only expenditure for additional construction and additional increases in debt would modify the basis.
 2. As an alternative the taxpayer could pay the capital gains taxes on proceeds received and then reinvest to enjoy a new depreciation base.
 3. The choice depends on the opportunity cost of money and the taxpayer's marginal tax rate (see CCH 908).
- B. For partial taking under eminent domain, the tax law differs between awards for the property taken and severance damages for the balance. In Wisconsin we do not make that distinction and so the total award reduces your basis on the remainder after allocation among land & depreciables.
- IV. Various forms of down payment sales contracts indicate best the distinctions between gain, realized amount, and recognized gain. There are three types which you should understand, installment sales, deferred payment sales, and contingent price sales.
- A. An installment sale occurs if the seller receives less than 30% of the sales price in the first fiscal year, including principle and interest payments on the land contract or purchase money mortgage. The realized gain is the difference between net adjusted sales price and adjusted basis. The recognized gain is the proportion of capital gain and ordinary income received as the ratio of adjusted basis to total sales price.

1. A down payment of 29% is dangerous if the government reallocates adjusted sales price between land, personalty, and finance charges; similarly a buyer's exercise of a partial release may trigger receipts in excess of 30%.
 2. If seller wants sales proceeds leveled over several years and buyer wants to pay it off ahead of schedule, it is necessary to use a substitute collateral trust managed by an independent third party so that control by the seller of trust funds cannot be interpreted as constructive receipt.
 3. A cash basis seller, who does not receive his purchase price in the year of sale in cash, notes, or marketable securities, does not recover any gain until he has fully recovered his adjusted basis. Thereafter the payments are capital gain or ordinary income depending on whether it was a capital asset or goods held in the course of trade.
 4. Even where notes are received in a sale not reported on the installment basis, it may be proven that their fair market value is less than face value. In that case, later collections are allocated between ordinary income and capital gain in proportion as the discount on sale would be to face value of the note. (See CCH 661)
- B. A deferred payment sale is one in which year of sale payments are more than 30%. In that case the profit is reported in the year of sale but can be adjusted for the discount value of notes taken. (See CCH 665, 666, and 667)
1. Uncle Sam will impute an interest rate to a deferred payment contract where interest rates are low or non-existent. This is called unstated interest. The current imputed rate is 6%. (See CCH 661, 682 and 683).
 2. Sellers prefer a higher sales price in lieu of interest so that gain is a capital gain and buyers may go along to receive a lower down payment even though it reduces their tax deductible interest expense. Imputed interest applies only to selling prices exceeding \$3,000 and payments after one year of date of sale.
- C. A contingent sales price occurs when the parties agree to adjust price in the future to resolve a conflict about assumptions, net income, allowable zoning density, or representations which don't prove out as to inventories etc.
1. In these situations the seller is treated as though he were in cash accounting and can recover all of his bases before paying taxes. The balance of the realized gain is only recognized after pay back of the adjusted basis. Income tax must still be paid on disallowed depreciation.
 2. For allocation between capital gain and ordinary income, see CCH 987 and 988.

- V. The student should also be aware of the distinctions between different classes of real and personal property which qualifies for special tax deductions or is exempt from depreciation recapture.
 - A. Section 1245 property is tangible equipment (not including the building or structural components) used as an integral part of manufacturing, production, extraction, transportation or utility. From time to time the government permits an investment tax credit on 1245 property.
 - B. Section 1250 property is depreciable except that it includes intangible real property such as leases, buildings and their structural components, and all other tangible real property that is not 1245. (Special features in a building for a specific occupant would be 1245 property while standard components would be 1250 property in the same building. Recordkeeping during planning and contracting stages of construction can produce significant shifts of assets to 1245.
- VI. 1245 property would qualify for bonus depreciation of 20% (CCH 1152). Basis is reduced by the amount of bonus depreciation. It is a one-time election method.
- VII. Student is urged to read CCH 1154-1167.
- VIII. Wednesday will discuss the class life ADR System (Asset Depreciation Range).

Lecture #13
Real Estate and the Federal Income Tax

- I. The conventional wisdom on real estate as an investment is that a major feature in its profitability is a favored treatment under the tax laws which make it at worst a major loophole for the rich and at best a very inefficient federal subsidy for construction industry. A few academics argue that there is some economic justification for the basic income tax treatment and capital gains laws but that the basic economics have been obscured by a patchwork of amendments and the propaganda of all the vested viewpoints that relate to the law.
 - A. Our purpose today is to first suggest some of the alternative tax strategies which can be implemented through real estate, a basic approach to tax analysis of a given investment problem, and finally some of the basic issues in the debate for further reform of the income tax law relative to real estate.
 - B. In essence the objective of any tax strategy is either to achieve the lowest marginal tax rate or to postpone the actual tax payment or a combination of these two elements.
 1. Reducing the tax rate is intended to maximize the share retained by the taxpayer.
 2. Postponing or timing the payment is related to the opportunity costs of money or present value.
 - C. It is not expected that you will learn all of the ins and outs of the tax laws but only that you see the alternative objectives and approach to structuring the deal.
- II. The basic alternative tax ploys can be identified and each can be given an example for illustrative purposes.
 - A. Deferral of income tax is the result of:
 1. Accelerated depreciation which understates taxable income in the early years and overstates taxable income in the later years. It may lead to recapture of tax shelter dollars at higher marginal tax rates than would have been paid if straight line had been used.
 2. Election to expense certain items such as overhead during construction rather than capitalize these construction costs will reduce taxes during the construction phase but reduce the depreciable value of the assets and therefore the value of accelerated depreciation during the operating stage.
 - B. Conversion of income to capital gain is the result of:
 1. Increasing the cash throwoff from a property through good management and marketing and selling the property for the present value of the future income.
 2. Purchasing a home with the help of deductible real estate taxes and interest and then selling it later for a capital gain.
 3. Accelerated depreciation (before recapture laws) permitted investors to understate income and then sell at an understated basis to increase his capital gain.
 - C. Deferral of the capital gains tax is a result of:

1. Involuntary conversion of a property to cash as a result of a natural disaster, casualty loss, or eminent domain permits investor to rebuild or relocate within a specified time without paying a capital gains tax.
2. The trade or exchange of like kinds of investment property is not taxed. Instead each party takes his old basis with him which is then adjusted for the net change in his debt position or the amount of "boot" he received. Boot is non-like property such as cash.

D. Avoidance of the capital gains tax could result from:

1. Sale of personal residence and purchase of another of equal or more value than your basis in the old property. For example, a couple could sell their home with a large capital gain and purchase a condominium unit for their retirement so long as the purchase price was at least equal to their capital gain.
2. Property could be held until the owner died and it was transferred to an heir. Once the estate and inheritance taxes was paid the heir would receive a new basis for the property equal to the value from which he paid taxes and these taxes could be considerably less than the capital gains tax.

E. The lowest marginal rate on a progressive tax rate scale might be accomplished by:

1. Installment sale of a property in which the seller receives less than 30% of the sale price from the buyer in the first year.
2. Income property could be owned by a corporation when the corporate rate was lower than the personal rate or owned by a short term trust when the beneficiaries tax rate was lower than the donor's tax rate.

F. It should be noted that these tax gains are not unique to real estate but would apply to any type of investment property including machinery, or securities, or other resources. The truly special tax treatment is given to the personal resident to encourage ownership, change in residence with a change in family status, and eventual liquidation of the capital represented by the home for retirement income.

III. The real estate investor has some difficulty in arranging affairs to pursue these various tax ploys.

A. There are three basic questions which need answer or definition:

1. Is the ownership entity a single tax or double tax entity?
2. What is the tax purpose of the investment.
3. What type of real estate is it for depreciation classification?

B. The single or double tax entity reflects form of ownership and certain specific economic attributes of the entity.

1. Single tax entities would include:

- a. Single proprietorship
- b. General partnership
- c. Sub-Chapter S Corporation
- d. Limited partnerships
- e. Other non-corporate associations

2. Double tax entities would include:

- a. Corporations not exempt above
- b. Associations for profit with three or more of the following characteristics.

c. In addition to characteristics of two or more people associated for profit, a ~~organization~~ ^{it} is corporate if: *it has 3 or more of the following attributes*

- a 1. Limited liability or investors
- b 2. Centralized management
- c 3. Unlimited continuity
- d 4. Marketable interests

D. Tax rules differ depending on the presumed purpose of the investment imputed to the taxpayer in any given property. There are three alternatives defined by the IRS:

- 1. For use (users have more liberal ordinary income - ordinary loss elections)
- 2. For investment income and long term appreciation (for which capital gain treatment is available with some elections to expense or capitalize holding costs)
- 3. For trade or inventory (dealers status for which capital gain is almost never available)

E. Since tax rules and depreciation allowed will differ by the type of real estate, a property must be classified both on the physical facts and the actual or implied intent of the owner among the following categories:

- 1. The personal residence
- 2. Farm or extraction properties
- 3. Investment residential
 - a. First user, or second user
 - b. Residential rehab
 - c. Conventional financing or federally funded and subsidized
 - d. Date acquired
- 4. All other properties (limited depreciation and full recapture)

X IV. While the tax rules applicable to real estate are generally consistent with other income tax accounting procedures, real estate tax policies have been the subject of considerable reform, pressure for additional reform, and a general suspicion that it is a special privilege domain of the rich.

A. One reason for the high silhouette of real estate income tax law is the fact that high financial leverage accentuates the benefits of ownership and the high value of even a small building means large dollar amounts are involved in small transactions. For the business man in a manufacturing plant, the accelerated depreciation of a single machine or an addition to his plant is a relatively minor adjustment to his income. For the real estate investor the hardware is the business involved and a very slow rate of turnover in terms of sales to value accentuates the tax significance which is tied to value.

1. Tax savings to other income is highest to those with the highest marginal rate.
2. The fetish of the rich to employ every tax strategem has become so irrational that they will spend \$1.50 to save a \$1 in taxes with the result that real estate development responds to the need for a supply of tax shelter rather than market needs for space.

☒ B. Such tax advantages that there are are justified according to some because:

1. Long term ownership is so risky, investors would not invest if payback was not accelerated by tax saving.
2. Unlike automobiles real estate depends on thousands of small investors for capital and could not compete for money unless there was an additional return in the form of tax benefits.
3. By attracting new capital to real estate housing construction is stimulated, but rents can be lower since the investor receives part of his return in the form of tax savings.
4. As a producer subsidy stimulates employment and maintenance of a competitive supply of space to reduce monopoly advantage of existing buildings.

☒ C. Those who oppose any tax features which permit deferral of tax or reduce taxes on the rich argue that:

1. Present tax laws lead to excess building and mis-allocation of national resources and priority.
2. The cost in lost tax revenues of 2-3 billion a year would be much more effectively used if collected and redistributed as a consumer subsidy for the low income family.
3. That ~~presently~~ the capital attracted to real estate is siphoned off by developers and brokers since most of the property has almost 100% financed anyway. *sup from*
4. ~~There is the basic suspicion that~~ the economic logic is faulty when it argues that to provide decent shelter for millions of Americans, the system must first produce several hundred thousand tax millionaires.

☒ D. During the next year some further reforms of real estate tax law can be anticipated because the real estate industry really consists of hundreds of thousands of small investors who are relatively disorganized. Moreover the trade organizations have lacked the continued programs and support which have characterized the oil industry or the mining interests. Such organizations such as NAREB have lost some creditability because of past positions with Congress which were reactionary, parochial or misinformed. Some of the reforms under consideration:

1. Limitation on artificial accounting losses by expensing development costs.
2. Reduction in accelerated depreciation or rapid writeoff of rehabilitation.
3. Permission for tenants to subtract proportionate share of real estate taxes and insurance just as the homeowner can.
4. Extension of capital gain holding period from 6 months to 5 years or more to encourage a longer term owner viewpoint.

E. Whatever tax reforms are created reformers will have to be careful that they do not destroy the economic incentive to invest in real estate by:

1. Extending the payback period for equity beyond 5 years
2. Forcing group payment of principal with after tax dollars so that solvency will depend on raising rents.
3. That development returns are reduced to the same level as other fields without the political risk and protracted time line of development.

Federal Taxes Due on Disposition

I. Taxes on disposition can be classified according to basic dichotomies as we have done in the past:

A. Contingency causing disposition

1. Voluntary sale
2. Foreclosure (construction receipt)
3. Condemnation for involuntary conversion through natural disaster or casualty
4. Exchange
5. Death

B. Classification of gain or loss

1. Capital asset
2. 1231 property

C. Type of tax entity

1. Individual
2. Corporation for profit
3. Corporation not for profit
4. Pension program

D. Type of property - Section 1231

Property used in trade or business. The definition of "capital assets" property. However, the law contains a special benefit provision (Code Sec. 1231) for grouping gains and losses from such properties (and some other properties described below). To determine whether Code Sec. 1231 applies, group all the gains on Sec. 1231 items and group separately all the losses on Sec. 1231 items. If the gains exceed the losses, each gain and loss is treated as though it was derived from the sale of a long-term capital asset. If the gains do not exceed the losses, each gain and loss is treated as though it was not derived from the sale of a capital asset. Thus, long-term capital gain benefits are extended where there is a net gain, and ordinary loss benefits are available where there is a net loss. Taxpayers use Form 4797 to report Sec. 1231 transactions.

In making the comparison, include (Reg. 1.1231-1, 1.1231-2):

(1) Property used in the trade or business, subject to depreciation and held for more than the required holding period for long-term capital gain or loss treatment (987).

(2) Business realty held for more than the required holding period for long-term capital gain or loss treatment (987).

(3) Trade or business property involuntarily converted and held for more than the required holding period for long-term capital gain or loss treatment (987).

(4) Capital assets involuntarily converted and held for more than the required holding period for long-term capital gain or loss treatment (987).

(5) A crop sold with the land, where the land has been held for more than the required holding period for long-term capital gain or loss treatment (987).

(6) Livestock, as explained at 970.

(7) Timber, domestic iron ore, or coal under conditions described at 986.

MINIMUM-MAXIMUM TAX

- I. Under the maximum tax provisions, earned taxable income is taxed at a maximum rate of 50%, favoring joint returns in excess of \$52,000 and single individuals in excess of \$38,000.
 - A. However, unearned income is taxed as if realized "on top of" earned income at regular rates up to a maximum of 70% so that an increase in earned income may result in unearned income being taxed at higher rates, a hidden tax on earned income and a reason for avoiding unearned income during years of high earnings.
 1. To postpone recognition of unearned income consider corporate form of ownership
 2. Gift assets to short term trusts if they generate unearned income
 3. Invest in tax exempt securities
 - B. The minimum tax on tax preference items adds a 15% tax on the amount of tax preference items in excess of \$10,000 or 1/2 income tax liability for one year, whichever is higher.
 1. Tax payers may spread tax preference items over the year to take full advantage of minimum tax exemption. Taxpayers may gift assets that generate more tax preference items than cash.
 2. Taxpayers may defer payments of investment interest or charitable contributions to avoid excess deductions for itemized accounts other than medical expenses and casualty losses.
 3. Years in which an individual has an unusually high taxable income may suggest the use of income averaging provisions which are elective and not eligible for maximum tax. Generally the maximum tax is of more benefit than income averaging where taxable income is earned. Income averaging computation should always be made when income is projected to be substantially higher than that of the preceding 4 years.
 4. Income averaging would follow this sample case:

Example: An unmarried taxpayer's average annual taxable income during 1972-1975 was \$7,500. His income consisted solely of salary in those years. His taxable income for 1976 was \$40,000 as a result of his winning a state lottery prize. His averagable income is \$31,000:

Taxable income for 1976	\$40,000
120% of \$7,500 average base period income	<u>9,000</u>
Averagable income	<u><u>\$31,000</u></u>

The tax on 1/5 of the averagable income (\$6,200) is \$1,740:

Tax on \$15,200 (120% of \$7,500 plus 1/5 of \$31,000)	3,574
Less tax on \$9,000 (120% of \$7,500)	<u>1,834</u>
Tax on 1/5 of averagable income	<u><u>\$1,740</u></u>

The tentative income tax, then, is \$10,534:

Tax on \$9,000 (120% of \$7,500)	1,834
Tax on averagable income (5 x \$1,740)	<u>8,700</u>
Tentative tax	<u><u>\$10,534</u></u>

The tax saved by averaging is \$3,856, the difference between the \$14,390 tax on \$40,000 without averaging and the \$10,534 tax with averaging.

The income-averaging rules apply to almost all types of income, including salaries, commissions, bonuses, interest, dividends, professional fees, ordinary income from sole proprietorships or partnerships, capital gains, wagering income, income from gifts or inheritances, and the like.

- C. The principle source of tax preference income continues to be the excluded half of long term capital gains which makes up about 85% of preferential income and thus reduces the advantage of declaring half the capital gain as income.

TAX BASIS OF PROPERTY UPON ACQUISITION

- I. The key to capital gains tax and the income tax is the tax basis of the real estate. Basis adjusted for allowable depreciation and capital improvements is the benchmark for capital gains tax and basis upon acquisition, allocated between depreciable and nondepreciable basis is the starting point for any depreciation system.
 - A. Tax basis depends on how a property may be acquired. - Purchase, inheritance, gift, compensation for services, satisfaction of indebtedness, dividend, and corporate distribution are examples.
 - B. Basis of property acquired by purchase is its cost. However, cost does not include allocated expense items like taxes, fuel oil, etc. or accrued interest on debt assumed.
 1. Cost can include expenditures to facilitate acquisition, such as
 - a. Broker's commission;
 - b. Cost of title search or title insurance;
 - c. Delinquent real estate taxes, if not deductible;
 - d. Legal fees;
 - e. Option payments;
 - f. Cost of acquiring outstanding leases;
 - g. Appraisal fees;
 - h. Payments to clear title;
 - i. Survey expenses;
 - j. Inspection fees.
 - k. Rezoning or variance or rezoning costs and fees.
 - C. Basis of property acquired by tax free exchange is the basis of the old property reduced by any boot and increased by any new cash, new debt, or gain recognized in exchange. This is true for property of like kind, replacement property for that lost to involuntary conversion, and the exchange of property for stock in a corporation controlled by transferor.
 - D. The basis of property acquired by gift is the basis of the donor immediately prior to the gift. There are two exceptions which is addition of the gift tax paid not to exceed market value of the property and cases where market value is less than the donor's basis.
 - E. Basis of property acquired by inheritance is the market value at the death of the testator.
 1. Property acquired by bequest, devise, or inheritance;
 2. Property acquired pursuant to a revocable trust;
 3. Property acquired pursuant to a trust over which the decedent retained controls amounting to substantial ownership;
 4. Property acquired as a result of the exercise or non-exercise of a general power of appointment held by the decedent;
 5. Property consisting of stock in certain foreign personal holding companies;

See paragraph
934 on page
329

See paragraph
960-61
on page
338.

6. Property acquired under community property laws,
 7. Any other property acquired from a decedent or transferred by reason of his death, if the property was includable in his gross estate for estate tax purposes, other than items constituting income in respect of a decedent.
 8. Property acquired by a purchase under an option exercisable only after the death of the option-or-owner.
- F. Basis of property acquired by gift in contemplation of death is fair market value at the time of death minus any depreciation, depletion, or amortization deduction taken by the donee following the gift but prior to death.
- G. Property acquired by a surviving joint tenant takes a basis in the hands of the survivor equal to market value of the share of the deceased.
- H. Property acquired by surviving spouse in a community property law state takes a new basis equal to market value at the time of the deceased's death.
- I. Property acquired as compensation takes on a basis of market value but the market value is taxed as income.
- J. Property acquired in payment of debt takes its fair market value on the date of transfer as the basis to the creditor. The basis of the debtor is not transferred because the creditor is entitled to deduct the amount of the debt in excess of market value as a bad debt. If value is unknown creditor must postpone bad debt deduction to the year in which he disposes of the property.
- K. Basis of property acquired on corporate distribution is its fair market value unless the property is liquidated under special conditions where the gain or loss realized does not have to be recognized.
- L. Basis of a property acquired subject to a mortgage includes the balance due at the time of acquisition, whether acquisition is by purchase, exchange, inheritance, or whatever, and the new owner need not be personally liable. The basis survives later negotiation to reduce the mortgage.
- II. Allocation of Tax Basis on Acquisition
- A. As a general rule, the acquisition price should be apportioned between land and buildings on the basis of market value. Tax assessment ratios will be considered but are not controlled.
- B. Basis allocation by contract would require the parties to set a market value on each item in the contract of sale.
1. If the allocation is arm's length because both parties are affected, the allocation will control.
 2. If allocation is important only to the purchaser, the IRS will disregard it.

- C. Basis allocation for a structure to be demolished is limited by the intent of the purchaser. If he intended to demolish the building, the entire cost of land and buildings will be allocated to the land. Salvage is an offset.
 - 1. If the new owner occupies them temporarily he can take depreciation for them for the interim.
 - 2. If he rents them temporarily his basis for depreciation would be the present value of the rents collected
 - 3. If after purchase a change in business conditions make the improvements obsolete, then he can write them off as an ordinary loss.
- III. Acquisition by option will permit the cost of the option to be included as part of the cost of the property.
 - A. If the owner fails to exercise the option and loses his payment, his loss is ordinary, capital, Section 1231, or a personal loss depending on the nature of the holding if he had acquired it (for use, for investment, for inventory, or for personal enjoyment).
 - B. Purchase for a bargain price from a stranger provides a basis, but if buyer and seller are related, the difference between value and sales price may be a taxable gift to one or the other.
 - C. Apportionment of real estate taxes on acquisition is discussed in detail in CCH.

Business 850 Lecture

An Approach to Organizing Real Estate Tax Issues For Real Estate Analysis

- I. On any particular tax question for a real estate investment, it may be useful to focus your search of regulations and materials by asking the following basic questions:
 - A. Is it a single tax or double tax entity?
 - B. What is the purpose of the investment?
 - C. What type of real estate is it by tax classification?
 - D. What is the basic tax strategy to be pursued?
- II. The single tax versus the double tax entity question begins with the form of ownership and ends with the economic attributes in terms of consequences of that form.
 - A. Single tax entities would include:
 1. Single proprietorship
 2. General partnership
 3. Sub-Chapter S Corporation
 4. Limited partnerships
 5. Other non-corporate associations
 - B. Double tax entities would include:
 1. Corporations not exempt above
 2. Associations for profit with three or more of the following characteristics
 - a. Limited liability or investors
 - b. Centralized management
 - c. Unlimited continuity
 - d. Marketable interests
 3. Sub-Chapter S or trust corporation violating conditions of conduit eligibility
- III. Purpose of investment must be established to classify the tax payer as to his position in any given property among these three alternatives:
 - A. For use (users have more liberal ordinary income - ordinary loss elections)
 - B. For investment income and long term appreciation (for which capital gain treatment is available with some elections to expense or capitalize holding costs)
 - C. For trade or inventory (dealers status)(for which capital gain is almost never available)
- IV. The type of real estate in question must also be defined both on the physical facts of the property and the actual or implied intents of the owner. Classifications might include:
 - A. The personal residence
 - B. Farm or extraction properties

C. Investment residential

- a. First user, or second user
- b. Residential rehab
- c. Conventional financing or federally funded and subsidized
- d. Date acquired

D. All other properties (limited depreciation and full recapture)

- V. Basic tax strategy either involves playing for the lowest marginal tax rate or timing of the actual tax payment or a combination of these. Tax rate issues are related to maximizing total share retained by the tax payer while timing issues are related to the present value or opportunity costs of cash. Basic tax strategies and several examples of tactics are given below. It is useful to read the tax text and classify various elements as tactics under each of the strategies.

A. Deferral of income tax

1. Accelerated depreciation
2. Election to expense rather than capitalize

B. Conversion income to capital gain

1. Accelerated depreciation on residential property
2. Upgrading personal residence

C. Deferral of capital gains tax

1. Trade or exchange
2. Involuntary conversion

D. Avoidance of capital gains tax

1. Trading personal residence for condominium
2. Holding for estate transfer and estate tax
3. Gifting of appreciating assets

E. Seeking lowest marginal rate on a progressive tax

1. Installment sale
2. Short term trust
3. Corporate conduits

INCOME TAX NOTES (Cont'd)

- I. Farming is a highly developed speciality in the tax code. It is necessary to distinguish between family farms, corporate farms, and hobby farms. The classification is significant since it controls the use of cash or accrual for farm operations.
 - A. (CCH 365) The 1965 TRA requires any corporation other than a family corp., a nursery, or a small corp. or any partnership in which a corp. is a member to use accrual accounting and to capitalize pre-production expenses.
 1. Pre-production expenses were abused by farm partnerships which expensed land clearing, irrigation, and orchard development expenses, selling tax losses through limited partnerships such as the Tejon ranch deal.
 2. Previously to plug the gap IRS had invented excess deductions, the accumulated total of farm losses in excess of income from farm operations. In later years if the farm land were sold these write offs would be recovered by converting a portion of the gain to ordinary income to tax the excess deductions.
 - B. A family corp. is one in which the members of one family own at least 50% of the corp. voting stock and at least 50% of all other classes of stock.
 - C. A small corp. is one in which it has gross receipts on a consolidated basis of less than 1 million/year. Once it exceeds 1 million it must change to accrual accounting and may not change back.
 - D. A corp. which primarily operates a nursery, forestry, or growing timber does not have to use accrual accounting. Fruit or nut trees are still considered farming.
 - E. Hobby farm. A person who operates a farm for recreation or pleasure is not regarded as a farmer. If there is a continual loss from year to year or a loss in 3 out of 5 years, the farming operation would be classified as a hobby farm.
 - F. All other individuals, partnerships or corp. which cultivate, operate, or manage a farm for gain a profit as owner or tenant are farmers. (CCH 771)
 - G. The code also recognizes a farm syndicate (CCH 367) as a farming enterprise which had to register as a security or one in which more than 35% of the losses are allocated to limited partners. In defining when an individual will not be treated as a limited partner or investment partnership, the code goes on to define the family partnership. An individual will not face accrual accounting if he:
 1. Lives on the farm on which the farming enterprise is being carried on,
 2. Has an interest attributable to his active participation for a period of not less than five years in the management of a farming enterprise,

3. As his principal business activity, actively participates in the management of a farming enterprise, regardless of whether he actively participates in the management of the enterprise in question, or
 4. Actively participates in the management of a farming enterprise involving the raising of livestock (or is treated as so under either (1) or (2)), and the enterprise in question involves the further processing of the livestock raised in the enterprise in which the individual is an active participant.
11. The benefits of cash accounting are not unlimited but there are some opportunities to shift farm income between tax years by purchasing all feed required in one and deferring crop sales or animal sales to another.
- A. Purchases of farm machinery vehicles, breeding, dairy, or work animals and drilling water wells are capital items usually subject to depreciation.
 - B. Unlike other businesses cash accounting farmers do not have to maintain inventory records and may purchase feed, seed and short lived supplies in advance of need and may postpone recognition of income with a variety of devices including storage for future delivery, production loans, or involuntary conversion revenues and subsidies.
 - C. However for the investor seeking capital gains, a farmer may deduct soil and water conservation expenditures involving matters of earth moving, etc. Similarly he can deduct assessments of drainage districts which finance capital improvements benefiting his land. (Disney World)
 1. The deduction is limited annually to 25% of taxpayer's gross farm income and must be deducted in the year paid or incurred.
 2. Excess expenses can be carried forward into succeeding taxable years without time limitation but not to exceed 25% in each year.
 3. Development of orchards and vineyards must now be capitalized except for taxes, interest, water, spraying and cultivating. Before 1976 institutions invested heavily in vineyards and orchards since they produce nothing but write offs for four or five years. (See CCH 367)
 4. Fertilizers and chemicals for soils conditioning can be written off in a single year at the option of the farmer.
 5. Land clearing expenses can also be deducted where clearing is for purposes of farming. The deduction is limited to \$5,000 or 25% of taxable income, whichever is less. (See CCH 1051-1053)

III. Eventually the IRS recognized farms were an excellent way to convert ordinary income into capital gain and found ways to recapture farm loss deductions in 1969 by use of the Excess Deductions Account and in 1976 by specification of accrual accounting(CCH 998).

A. From 1969 through 1975 an individual whose adjusted non-farm income exceeded \$50,000 and net farm losses exceeded \$25,000 was required to accumulate all farm net losses, from which he could subtract taxable income in the good years. At the end of each year, the EDA balance was compared to sales and exchanges of farm recapture property. If EDA balance was higher, gains were ordinary income well gains in excess of EDA could be capital gains.

1. Farm losses were recaptured against sale of depreciable personal property, cattle held for more than two years, land held for more than one year and unharvested crops.
2. Relative to soil and water conservation deductions and land clearance expenditures which were deductible, there was a further recapture. If land was held five years or less the recapture percentage is 100% and then dropped 20% each year until there is no recapture after the tenth year.

APPRAISAL AS A SPECIAL CASE OF FEASIBILITY ANALYSIS

Feasibility	Appraisal
Will it work?	What will it sell for?
- Objectives - decision standards - Maximize spendable cash of total enterprise - Subjective gratification - Adaptation to enterprise management specialties & weaknesses - Aggregate market potential opportunity identification - Merchandising analysis (defining competitive edge) - Legal-political context - All legal constraints on site, seller, buyer, and user are considered - What is legal is qualified by what is political - Physical-technical constraints are examined in terms of what might be - Financing from buyer viewpoint considering all profit centers - Income tax advantages or disadvantages affecting spendable cash - Revenues and expenses forecasted for each period of development timer horizon - Limiting assumptions of solution - Average outcome without qualification as to alternative futures - Responsibility denied for other areas of expertise - Date of appraisal edits conformation scope - Format of analysis determined by structuring of data to lead to desired conclusion or recommendation	- Objectives - decision standards - Maximize value of individual parcel - Economic surplus - Prudent behavior - Aggregate market potential business climate - Merchandising comparison (defining standard competitive substitute) - Legal-political context - Legality assumed - Limited to site use rather than probable user as alternative buyers are assumed. - Physical-technical constraints are studied as is or in terms of conventional wisdom - Financing from lender viewpoint considering only net income line and below - Income tax not considered except implicitly recognized in market comparison - Revenues and expenses generally normalized and projected for standard period - Limiting assumptions of solution - Identification of potential variance and sensitivity of objectives to alternative futures - Responsibility allocated among sources of expertise - Budget & purpose of study edits information scope - format of analysis defined by model of fair market value appraisal report

An Approach to Real Estate Investment Strategy

I. Most decisions about real estate investment should be made before any specific property is examined. Then you have a need in search of real estate which will fit. Critical needs will be stated in terms of a preference trade-off matrix.

A. Satisficing model ~~not~~ appropriate

B. Homeowner might set up his preference as follows:

1. White neighborhood more important than anything
2. Old neighborhoods more segregated more important than large lot
3. Large lot more important than new
4. Good schools more important than new
5. Roomy house more important than roomy lot

Choice: old neighborhood, good school, large house, small lot

C. The hierarchy of preferences for sophisticated investors today is:

1. Political exposure
2. Marketing monopoly (lock-in)
3. Management intensiveness
4. Financial characteristics
5. Decision points - cut and run with defined loss
6. Federal and state tax posture
7. Fit to estate building or distribution plan

II. Political exposure

A. Public land use controls

B. Political controls on prices or user effective demand

C. Political constraints on peripheral operations

III. Market control

A. Direct control of ultimate user

B. Indirect control through reciprocity

C. Channeled demand because of terrain, utilities, or site linkages

D. Consumer research to establish market gaps

IV. Management intensiveness

A. Sale less than long term triple net lease

B. Long term triple net less than multi tenant with escalators which in turn is less than gross residential leasing

C. Alternative is spectrum of development starting with passive land positioning, packaging, site development, construction and marketing, and long term management.

1. Each requires less entrepreneurial foresight and innovation

2. Each requires more administrative execution of a plan
3. Each requires more intensive capital risk
4. Each is more sensitive to time delays

V. Financial characteristics

- A. Profit centers
- B. Risk measures
- C. Time line
- D. Sources and rates of return

VI. Decision points

- A. Structuring the deal to provide for contingent commitments at a minimum of sunk cost
- B. Structuring the financial hedge
- C. Procrastinating on decisions

VII. Federal taxes

- A. Short term viewpoint
- B. Long term viewpoint

VIII. Fit to estate accumulations and distribution plan

- A. Management continuity
- B. Liquidity
- C. Form of distribution
- D. Investment flexibility
- E. Form of ownership

Equity Investment Yield - Lecture #5

I. (unfinished business)

- A. The Harvard Probability Model is cash flow analysis with a basian approach to key assumptions. Each input is given 3 points to establish a range and central tendency which does not require normal distribution curve. Computer picks points on the curves at random and combines into 100 pro forma statements to state probability. It must assume total independence of each variable.
- B. The alternative approach is sensitivity analysis of those variables which have the highest likelihood of variance and then controlling by contract, staging, or monitoring to hold variance within acceptable limits. For example, pre-leasing of motel rooms to meet default points or construction contracts which permit no unexpected extra charges.
- C. Jim Pappas has a technique for factoring cash flows to compute acceptable tolerance for variance and this could prove a useful term paper for the mathematically inclined.

II. Yield on Real Estate Equity Investment

In discussing investment yield we need to break the subject into a variety of sub-sets of issues.

- A. The first we have mentioned earlier is the difference between prospective yields and retrospective yields.
- B. A second problem is the degree to which we confine the benefits to a single investment or expand the context to include the total impact on portfolio yields, particularly on an after tax basis.
- C. A third problem in real estate is the degree to which you distinguish between profits attributable to active management as opposed to passive investment. This is a major problem as soon as you take a profit center approach. When is the developer making an investment profit on his land and when is he making an entrepreneurial profit on his wise use of the land, or his construction margin, his property management margin, etc.
 - 1. Consider the acquisition of an apartment project with 100% financing and no net spendable cash after debt service and taxes. The "owner" picks up 8% of gross for property management and another 2% for insurance and the debt service contract. Is that an investment or a business commitment?
 - 2. Is an investment an outlay of capital or can it be just a stand-by guaranty position?
 - 3. When is an investment to capture a business profit a business expenses as opposed to a passive investment? In this course an investment is simply one or more outlays followed by one or more periods of positive cash proceeds. Otherwise how do you decide if advertising expenditures are an expense or an investment - by duration of proceeds?

D. Capital budgeting decision makers distinguish between the conventional investment and a non-conventional investment. Both presume outlays at the beginning of the period and proceeds are earned at the end of each period, generally one year.

1. A conventional investment has one or more periods of outlays followed by one or more periods of positive cash proceeds.
2. A non-conventional investment has one or more periods of outlays interspersed with periods of positive cash flows.

E. Investment decisions based on yield are attempting to provide a mechanism for choosing between alternative courses of action.

1. Accept or reject decisions on independent investment, generally accepting it if yield is greater than some minimum acceptable rate of discount. (cost of money)
2. Mutually exclusively investments requires choosing the best of a set of alternatives which may all be profitable. A plant location where you will build only one plant or an engineering decision to trade off one feature for another. Yield methods may give less accurate rankings for mutually exclusively decisions because they reflect average rather than incremental cash flows - marginal revenue versus marginal revenue costs.

III. 3. Investment ranking will be shown to work best for pairs of alternatives and disintegrate as the number of alternatives increases.

Refer to table of hypothetical investments. To some degree it is possible to rank by inspection.

- A. Two investments have identical cash flows each year through the final year of the short-lived investment, but one continues to earn cash proceeds in subsequent years. The investment with the longer life would be more desirable. Thus investment B is better than investment A, because all things are equal except that B continues to earn proceeds after A has been retired.
- B. Two investments have the same initial outlay and the same earning life and earn the same total proceeds. If at the end of every year (during their earning life) the total net proceeds of one investment are at least as great as, and for at least one year are greater than, the total for the other investment, then the first investment will always be more profitable. Thus investment D is more desirable than investment C, because D earns \$2,000 more in year 1 than investment C does; investment C does not earn this \$2,000 until year 2. The earning of \$2,000 more in the first year leads to the conclusion that investment D is more desirable than investment C.

IV. Payback Period is a frequently used measure of economic value and measures the total time for recovery of the original investment for long term investments it is also the reciprocal of yield.

- V. Average income of the book value on investment. Generally they use the average book value which is the investment divided by 2. It fails to rank correctly because it does not consider timing of proceeds.
 - A. The alternative is to divide income by cost of investment without considering accumulated depreciation.
- VI. The yield of an investment method seeks to avoid arbitrary choice of a discount rate. Procedure is to find a rate of interest that will make the present value proceeds equal to the present value of the present cash outlay.
 - A. Yield may also be described as the rate of growth. In a conventional investment yield represents the highest rate of interest one could afford to pay for 100% financing under conditions of certainty.
 - B. By inspection we determine that investment B was preferable to A and D was preferable to C and this is the first method of analysis which gives the same ranking.
 - C. The net present value concept uses a selected rate of interest to compute the present value of cash proceeds and outlays and ranks the investment by the net difference.
 - D. Note that the rankings change between 6% and 30% depending on the degree to which proceeds are postponed.
 - summary
 - E. In looking at a ~~set~~/of rankings it is obvious that each technique gives a different ranking so that one must choose standards of evaluation with care and know when they measure yield as opposed to some other quality. Quality criteria may not be financial parameters but rather a matter of attribute analysis and we may wish to use weighted point totals to establish a ranking matrix.
 - F. In effect accept or reject decisions or choosing the best of exclusive alternatives are much narrower and more modest goals than "ranking of investment."
- VII. Some authors suggest a variance of the present value method called a index of present value which is to divide the present value of cash proceeds by present value of outlay to determine relative dollars of proceeds per dollar of outlay. If the index is larger than 1 accept the investment but this produces the same result as a positive net present value. However, it can mislead because it does not consider scale of investment and classification of cash flows.
 - A. Refer to last table and note that the index indicates x is preferred to y while net present value is higher for y because the incremental index is greater than y.
- VIII. A non-conventional investment occurs when periods of net proceeds are interspersed with periods of net outlay. While a conventional investment will have only one yield, in a non-conventional investment any of the following is possible:
 - A. The investment has no yield since you cannot solve a binomial equation for a real number. For example, proceeds of +100, -200 and +150.

- B. The investment has one yield (or one real number root).
- C. The investment has more than one yield with more than one root to a quadratic equation.
- D. If the present value method is used as the final criterion, rules for making correct decisions are very simple for the conventional investor:
 - 1. For each investment proposal, compute the net present value of the proposal, using the cost of money as the discount rate.
 - 2. If the choice is between accepting or rejecting the investment, accept it if its net present value is greater than zero, and reject it if the net present value is less than zero.
 - 3. If a series of investment proposals is available and the present value of each is greater than zero, but only one can be accepted, then accept the one for which the present value is the greatest, provided its present value is greater than zero.
- E. The yield method for making correct investment choices depends on the premise that the cost of the money is the same for all future time periods and the following complexities are recognized and met in each case:
 - 1. A single investment may have more than one yield. The present value of the cash proceeds from an investment may equal the present value of the costs at x and at y per cent. This may mean that the investment is profitable only if the cost of money is between x and y per cent, or it may mean that the investment is profitable only if the cost of money is either less than x per cent or greater than y per cent.
 - 2. If a group of two or more mutually exclusive investments is available, a direct comparison of their yields will not necessarily lead to the correct choice of the best alternative. It is necessary to analyze the investment proposals two at a time, decide which one of each pair is more desirable, and then compare the more desirable investment with one of the others, to decide which of those two is more desirable, continuing until by a process of elimination the best one can be determined. By contrast the present-value method indicates immediately which one of a group of mutually exclusive proposals is more desirable.
 - 3. In interpreting the yield of a single investment, it is necessary first to determine whether the cash flows correspond to an ordinary conventional investment or to a loan from the point of view of the borrower.
 - 4. It may not be possible to define the yield for a cash flow series. In this case the easiest procedure is to interpret the cash flow series using the present-value method.
 - 5. If the cost of money is not expected to be the same in all future time periods, then the yield method as defined in this book cannot be used to give the same decisions as the present-value method.

Risk Measurement in Real Estate

- I. Risk measurement in a real estate venture must be related to the viewpoint of a particular actor in the project. The probabilities of the project's success or failure or degrees of same are not those of the individual actors.
 - A. Emanuel Halper in "Coping with Commercial Development Risks" provides the extreme or ideal case, "For the commercial developer there are two concerns which motivate endless struggle. One is to pass risk on to everyone else but himself and the other is to spend everyone else's money but his own."
 1. The literature supports the concept of developer minimizing maximum potential loss up to the commitment point and the costs of time exposure from that point forward.
 2. In contrast, lenders are seen trying to maximize the amount of contributed capital subordinate to their own.
 3. The long term equity investor seeks to limit personal liability arising from any aspect of development activity.
 - B. Hence maximum potential loss and the degree of risk in future assumptions must be examined from each individual viewpoint as well as relative to the project. Project risk is often called business risk, while each individual viewpoint reflects financial risk.

II. Common measures of risk

- A. The standard deviation of the distribution of expected return

$$\sigma_t = \sqrt{\sum_{x=1}^n (A_{xt} - \bar{A}_t)^2 P_{xt}}$$

A_{xt} = cash flow for the x^{th} possibility in period t

P_{xt} = possibility of that occurrence in period t

$\bar{A}_t$ = expected value of the cash flows in period t

- B. To measure risk per dollar of investment, the standard error is converted to a coefficient of variation.

$$V = \frac{\sigma}{\bar{A}_t}$$

V = coefficient of variation

σ = standard deviation

$\bar{A}_t$ = expected mean cash flow in period t

- C. The article by Michael Young is simply the extension of that to a series of independent or related errors in assumptions. Note that the interest rate could also be expressed as a standard error although he chose not to.
- D. Another simplistic risk system is to adjust the discount rate upward to compensate for perceived increases in risk, producing a lower present value since uncertain future receipts carry little present weight.
- E. Some financial analysts use the certainty equivalency method in order to put alternative investments on a parody basis for ranking. Cash flows are first adjusted to their mean probable value (certainty equivalent) and then discounted at the risk-free discount rate.
- F. Sensitivity analysis indicates the change in value attributable to a change in one specific assumption at a time.
- G. Simulation analysis can be a more complex method of sensitivity analysis.
 - 1. Probability distributions of specific uncontrollable variables will permit the multiple production of alternative investment outcomes. These outcomes can be displayed as a frequency distribution.
 - 2. When probability distributions are generated from a normal distribution curve these models are called Montecarlo Methods because the sum of all alternative outcomes remains constant. Mike Young's model is such a model since standard error is based on normal distribution where the mean and the median are equal.
 - 3. The Mike Miles model uses a three-point curve. These input distributions are termed Uncertainty Profiles while the resulting output of cumulative frequency distributions are called Risk Profiles.
- H. The basic problem with most of these models using Montecarlo techniques are as follows:
 - 1. The use of the expected value of the random variables will not give an accurate estimate of the expected value of the project.
 - 2. The values of the variables over time are not independent.
 - 3. The different variables for each period are interdependent.
 - 4. The technique gives no indication of associated risk.
- I. In the Pellat article, he alters probability to account for time and intraperiod dependencies but he does not provide coefficients which reflect the magnitude among the variables. One way to do that would be to work with net income variance from the normative as that should be less volatile than any one of the items above the net income line.
 - 1. The Pyhrr model does not address either criticism #2 or #3. Steve claims it does not change the results because if air conditioning and utilities costs go down real estate taxes and deferred maintenance may go up, since management in the short run will improvise to live within their total cash budget.
- J. External risk beyond management's control can be stabilized through diversification. Scale of operations, smaller individual investments, and insurance, are all forms of diversification. Internal risks relate to management skills and the rate of response and improvisation which management may utilize to adjust to variance. Good management and a realistic budget make the budget a self-fulfilling prophecy; therefore, risk analysis first begins with the negotiated contract, then with managerial ability, and finally with financial recognition in the investment decision.

RISK ISSUES FOR EQUITY INVESTMENT

- I. First Level of Risk - Cushions for Surprise
 - A. Benchmark ratios
 1. Debt cover ratio
 2. Default ratio
 3. Loan to value ratio
 - B. Quality of income tests
 1. Ratios of tenant by size, term, and credit rating
 2. Guaranty's and master leases
 3. Indexing for inflation
 - C. Stabilizing spread
 1. Expense stops
 2. Reimbursables (CAM)
 3. Escalators
 4. Designs to shift responsibility
 5. Triple net lease to match debt constant
- II. Sensitivity Analysis
 - A. Testing for adequacy of cushion in dollars
 - B. Testing for variance in time
 - C. Testing for ruin
 - D. Testing for minimax returns
- III. Density Modeling
 - A. Probability of alternative outcomes
 - B. Cumulative probability of positive or negative outcomes
 - C. Discontinuous scenarios
- IV. New Response Theory Models
 - A. Cumulative and progressive
 - B. Interactive rather than independent variables
 - C. Premise of control rather than random response
 - D. Surface or flow continuum rather than series of independent events (Westby, Feb. 6)

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- I. Coming Trends in Real Estate Equity Investment
 - A. Changing product to emphasize capital pools
 - B. Significant reform of marketing patterns for both sellers and buyers of real estate
 - C. Significant stratification of the market
 1. Institutional investment quality and process
 2. Corporate centers of expertise in production, management, and financing
 3. Small-scale personal investment entities
 4. Quasi-public subsidy of real estate with high national priorities
- II. Since bank trust departments are exempt from SEC regulations and wish to be full-service advisory agencies, units like FARA will spawn a number of entities for real estate investment.
 - A. Both a co-mingled and closed-end fund
 - B. Personal trust units or estate trusts
 - C. Sale of limited partnership units of tax shelter in closed-end fund
 - D. Specialized property funds for the risk takers
 - E. Corporate pools of real estate listed on the exchange
- III. The commercial property broker is doomed to a significant reduction in terms of importance and fee schedule.
 - A. Institutions prefer to deal directly and pay only a finder's fee
 - B. Sellers can auction investment quality space using real estate counselors and accountants
 - C. More property will change hands through network of counselors working for a fee with incentive features, including accountants, investment bankers, and appraisers/counselors
 - D. Marketing specialists will charge specific fees for specific services, generally not contingent on sale
 - E. Property turnover will be less frequent as big funds will buy and hold and upgrade. Brokerage emphasis will be on finding tenants to occupy institutionally-owned property
 - F. Institutions will inventory data on desirable properties and be prepared to buy and close quickly with a large staff of experts
- IV. Stratification of the market will be brought about by the unwillingness of institutional investors to purchase properties less than \$3 or 4 million each and the inability of personal investors to raise sufficient capital to purchase more than \$500,000 to \$1,000,000.
 - A. Stratification will represent those willing to renovate old commercial structures and leasing patterns as distinct from those passive investors who want a new building fully leased without energy obsolescence.

- B. Stratification by type of property since many funds require stratification by the presence or absence of seller financing
- C. Stratification by metropolitan economic base and

Equity Investment 850

- I. Roulac provides a number of items we have not discussed but which we should underscore as they point out the need for analysis of outlay receipt pattern on an after tax basis for a variety of investors.
 - A. Chap. 17 on tax exempt investors is notable in light of his discussion that it takes leverage and depreciation working together to improve after tax rate of return.
 - B. A tax exempt organization such as a pension fund is limited by IRS rules on "unrelated business income" to either:
 1. Purchase of investment real estate on an all cash, no mortgage basis to preserve tax exemption, or
 2. If a mortgage is used then the income attributable to the asset acquired is taxable. However, determination of the income tax is modified because:
 - a. the tax exempt investor is limited to straight line depreciation
 - b. The tax rate is reduced to the degree that the debt is less than the investors tax basis.
 - C. The impact of leverage of real estate investment performance, i.e., modified or internal rate:
 1. Lowers original outlay
 2. Increases ratio of sales consequences to initial equity investment
 3. Depends on opportunity costs of funds
 4. Note also that Roulac also includes a working capital reserve (\$25,000)
 - D. Chap. 21 provides a good example of the need to measure the tax effect of leverage and appreciation, pp. 369-384 should be understood by any real estate graduate.
 - E. Depreciation policy in the past was based purely on present value of immediate tax savings. However, the investor will now have to relate that to the risk and tax preference costs:
 1. Recapture creates a tax trap which undermines the apparent limit of liability on a non-recourse loan should it be foreclosed.
 2. A 15% tax on accelerated depreciation may reduce the tax advantages to a point where the single tax conduit is more trouble than its worth
 3. Greater emphasis on commercial properties with straight line depreciation only or non-leverage investment by tax exempt may depreciate sales prices on some income property.
 4. Costs of energy issue and shifts in life style may require investor to protect liquidity by avoiding tax traps.
- II. Roulac has made a specialty on the subject of compensating the sponsors and I have placed great emphasis on the management intensiveness factor for any particular investment.

- A. Roulac is negative on investment when a sponsor combines his role with that of developer. On the other hand the general partnership generally works where the managing partner is both well financed and well experienced typically the developer will want the building contract but will permit competitive bidding of property management.
- B. Roulac also believes that compensation in the form of a real estate brokerage or architectural commission creates an immediate conflict of interest through acquisition price overruns, financed with excessive debt and inadequate cash reserves.
- C. Therefore participation compensation interests are preferred but the accounting terminology is critical (as noted in our introduction to limited partnerships). Roulac sees four parts to a fee formula:
 - 1. Expertise and access to the best deals
 - 2. Reimbursement for out of pocket costs
 - 3. Motivation needs to tie rewards to performance or one party or the other will have a decided edge
- D. The front end load should be reimbursement for the cost of search and acquisition, just as the mortgage banker makes no money on the points up front but rather than on the servicing fee. Nevertheless the investor must reimburse fully since the real success of the investment is determined by the price and terms of purchase, more so than future economic conditions.
- E. The appendix on page 517 on management of the real estate venture process should be studied carefully by those who think they immediately want to be a general partner or packager. Most of that is legal and accounting work rather than real estate field work. Moreover compare that list of responsibilities to the performance of our local hack real estate brokers.
- F. Since California typically leads in real estate regulation you should be familiar with appendix 6 581 and appendix 7 590.

1. Farm investment is heavily related to real estate, leverage, and tax shelters but agribusiness as an investment has a number of unique characteristics which distinguish it from other forms of real estate investment.
 - A. Investor may select an agricultural specialty which is totally unregulated by the government, subsidized by the government or totally dependent on government price setting. Real estate is similar in that some investments may be laissez faire, some may be subsidized with loans, tax treatment, or service costs, and some may be price controlled as in low income housing.
 - B. Agricultural producers are the only segment of U.S. business which are permitted to employ cash accounting principles.
 1. A farmer on the cash basis does not use inventory. He is entitled in the year of payment to deduct costs of farm management services, taxes, insurance, labor, materials, and supplies used in cultivating approved crops and raising livestock.
 2. He has no accounts receivable or payable for computing taxes.
 3. Capital items such as the free operation stage of orchards, vineyards, and ranches may be expensed.
 4. Purchase of livestock for draft, breeding, dairy, or sporting purposes is considered a capital cost, entitled to an investment tax credit and depreciable.
 5. The total effect is to give the farmer great flexibility in timing revenue and expenses; in good years he may purchase ahead, reducing taxable income and reducing some of the cash consequences of a poor crop in future years.
 - C. A person who operates a farm, whether partnership or corporation or individual is designated a farmer.
 - D. A person cultivates or operates a farm for recreation or for pleasure i.e., which does not have a profit two out of five years is not a farmer.
 - E. A farmer on the cash basis must include in gross income all cash, merchandise, or property received from the sale of livestock and produce which he has raised, profits from the sale of livestock or other items which were purchased, and gross income received from all other sources.
 1. Profit from sale of livestock is computed by deducting cost from sales price, except:
 2. Animals bought as draft animals, for breeding, dairy purposes, or not for resale such as sheep, the profit is the difference between sales price and depreciated basis.
 3. Income from livestock sold due to drought in an area designated eligible for assistance can declare the proceeds income in the year following sale.
 4. For the farmer who doesn't qualify for a cash basis he must maintain inventory on livestock raised or bought for sale on the farm price method or the unit livestock method.
 - a. Farm price method is current market price less the direct cost of disposition.
 - b. The unit livestock method can be used when the farmer raises his own livestock or feeders. All animals in a single class

are valued at a single unit price reflecting normal cost of production. Farmer must treat all his animals this way or none.

- F. Farmers who receive loans from the Commodity Credit Corp. may treat it as gross income in the taxable year received even though the farmer may not put the grain to the credit corporation until the following year.
- II. Starting with 1977 the Tax Reform Act has greatly reduced the flexibility of tax accounting for farm corporations and investment syndicates as a result of the investment, both legitimate and fraudulent, in the early 1970's in both cattle, irrigation farm land, orchards and vineyards.
- A. Any corporation in farming must be taxed on accrual basis as well as any partnership in which a corporation is a partner. Moreover, pre-production expenses must be capitalized other than taxes, interest, and casualty loss.
 - B. The exception is a sub chapter S corporation, a family corporation, a nursery or a "small corporation".
 - 1. A family corporation is one in which the members in one family own directly or through attribution at least 50% of the corporations voting stock and all other classes of stock.
 - 2. A nursery corporation also includes the growing of timber.
 - 3. A small corporation means one which has gross receipts including income from related corporations of \$1 million or less. If gross receipts ever exceed \$1 million it must switch accrual accounting and may not change back.
 - C. A farming syndicate can only deduct expenses for feed, seed, fertilizer and similar supplies no earlier than the year in which such items will be used.
 - 1. It is interesting to note that the law is directed against any kind of farm enterprise for more than 35% of losses are allocated to limited participation individuals who do not actively participate in the enterprise. Nevertheless the law exempts people who are farmers or who live on the farm on which the joint enterprise is carried out.
- III. Agricultural marketing which produces the revenue which supports the investment enjoys a number of special advantages over and above most real estate investments.
- A. A series of special banks with subsidized money costs exist:
 - 1. Federal land bank
 - 2. Federal intermediate credit banks which serve as intermediate supervising the reserve banks for production credit associations.
 - 3. Bank for cooperatives specializes in funding agricultural buying and marketing coops.
 - 4. The commodity credit corporation to provide low cost storage, price supports, warehouse loans, and crop purchasing outlets.
 - B. Existence of a futures market allow producers to reduce risk through hedging.

- C. Tax reform acts of 1969 did create a limit on tax payers whose non-farm adjusted farm income from salary, fees, dividends, etc. exceeded \$50,000 and whose current farm losses exceed \$25,000. Though farm losses are still deductible an excess deductions account EDA must be maintained for portion of losses over \$25,000 and when farm property is disposed of in later years, the capital gain equal to the amount of EDA will be treated as ordinary income, a form of recapture. If a taxpayer has less than \$50,000 of non-farm income no addition to EDA must be made. To minimize growth of EDA, personal income as well as farming costs must be carefully programmed.

Notes on the Real Estate Investment Trust

- I. Three phases of development characterize history and type of operating trust.
 - A. First generation trusts are those which converted from the old time Massachusetts Trust which survived the depression or those which were created for equity investment following the IRS law of 1960. These trusts generally took passive investment as owners of apartment, office, motel, and shopping center projects.
 - B. Second generation trusts were modeled after two mortgage trusts FMI and NAT and represent an alternative strategy which avoids the weakness of the equity trust format.
 - C. The mixed trust is a first generation trust which is borrowing on its book equities to make mortgage loans to supplement its equity income.
- II. The advantage of a first generation trust is to distribute ownership of large scale projects among small scale investors who can thereby enjoy the leverage cash flow of real estate. The cash throw-off was more significant in the days of 5% interest rates and with older buildings acquired in the 30's in key locations which then benefited by inflating rents. That investment pattern has three problems:
 - A. The trust must pay 90% taxable income. When depreciation is gone there is nothing to cover principle payments on the mortgage from classification as taxable income. Mortgages must be small relative to the total value of old buildings which have been depreciated and since there is little growth in retained earnings high mortgages are necessary on new buildings.
 - B. Accelerated depreciation on traditional investments of equity trusts has been reduced even for a new building and interest rates, real estate taxes and market price trends have meant that larger projects have no cash flow in the early years.
 - C. Investors in real estate trusts were drawn by income rather than growth and since capital gain sales are limited in any one year liquidating value had little influence on price. Prices were determined on a p/e basis and the newer the trust portfolio the more likely it sold at a discount from par.
 - D. Equity trusts existed largely as a dumping ground for property spun off by inside investors seeking diversification or gradual liquidation by means of certificate sales rather than installment sales. Others found it useful to control insurance, construction, legal, property management, or land purchases of the trust.
- III. The second generation trust followed a whole new strategy as it worked on short term and intermediate loans with lending capital borrowed at whole sale rates and secured by an underlying mortgage portfolio purchased with funds generated from security sales. The spread between interest earned and borrowed fund costs was all available for payments on the equity.

- A. Note that principle payments on debt are covered by repayment of loans.
 - B. For many years the mystery on construction loans provided a spread of 4 or 5 points on these loans relative to the prime rate. Trusts cannot participate in profits but can do so indirectly as the construction loan makes all the other profits for the developer and therefore has a relatively elastic demand curve. Moreover, some developers are permitted to operate on intermediate financing on the theory that the project once completed will create its own market.
 - C. Share holders money is invested to a large degree in a relatively permanent mortgage portfolio which has been assembled prior to the public offering by the promoter so that the underwriting can be fully invested at once at market rates, with much of this underwriting occurring in the recent period when rates were high, say 9%. If loans could be made with a bank at 8% and relent on construction loans at effective rates of 14%, these monies representing 50% of the basic portfolio would increase the overall yield on stockholder base to 12% and a 90% payment would permit a prospectus suggesting a 10 to 11% income return.
 - D. A high return would be discounted by the market on a price earnings ratio, raising the price of the trust share well above par. It is then possible to sell a second issue of stock in lesser quantities at a higher price to improve the earning power of the trust further. This strategy is called contradilution by Cornelius Rose. It provides a method of providing reasonable growth as well as high cash dividends.
 - E. The strategy falters unless you have close ties to large amounts of credit and a generator of construction loan or intermediate loan opportunities which are not attractive to the banks, the traditional specialists in short term debts with a self liquidating feature called a letter of commitment from the permanent lender. The spread on construction loans has fallen to prime plus 3 or 3 1/2% and not all trusts can remain fully invested and leveraged without accepting some very marginal deal.
- IV. The mixed trust is an old equity trust in the process of conversion. In addition to borrowing funds on its real asset values rather than its book values, it may be liquidating some of its old holdings gradually to generate capital gain.
- A. Capital gains or income covered by depreciation tax shelter means that some of its dividend may be a tax free distribution of capital until such time as the investor has recovered its basis.
 - B. In addition the trust with some cash flow from its mortgage lending operations or capital gains from variations in the mortgage market will be able to maintain a small dividend while investing in long term situation such as land, special situations as rehabilitation, or financing of real estate corporations such as modular home manufacturers, etc.

- V. The explosive expansion of the second generation trust is leading to some significant problems in terms of increased regulation and decreased investment opportunities.
 - A. Perhaps the major unresolved issue is conflict of interest between policy holders or shareholders in two related enterprises such as a bank or an insurance company and their captive trust.
 - 1. There are problems in determining which unit received which share of the loan depending on risk, supply of credit and who controls the deal.
 - 2. The IRS law is relatively simple minded about insider dealing
 - 3. Fee schedules have called in for question by the SEC.
 - 4. Bank holding companies which control the management companies which control the trusts are raising eyebrows of those who regulate the banks as the banks advance funds to the trusts which makes deals the bank would never be permitted to make.
 - B. A related problem is the scarcity of well trained personnel and good loan contacts which mean the trust either depends on the mortgage department of its sponsor or the integrity of its correspondent which may make it too passive.
 - C. The premise that large trusts means sophisticated management which the little investor could not otherwise afford is blunted by the fact that the trust must remain passive and contract away management to local property management firms. Furthermore, it is management of these development phase which creates the largest profit for real estate and this opportunity the trust is denied as it cannot participate in profit nor provide the management.

Real Estate Finance
Real Estate Securities Issue

- I. Since development and construction operations requires so much capital recently there has been a trend of renewed public interest and corporate attention in the securities market as a source of capital.
 - A. Equity capital is reaching housing from two sources:
 1. The sale of additional shares of housing company stocks.
 2. Direct equity investment in operating companies.
 - B. Investor interest in stocks has caused stock prices to soar. From January 1967 to January 1968 the housing stock index rose 90% and from 1968 to 1969 the index increase runs slightly less as price earnings ratios have shifted direction. For example, Kaufman & Broad, the nations largest home builder had a PE shift from 7 to 30 to almost 50.
 1. The big company have been expanding profit margin because of their ability to cut cost and stabilize operations by building in several market areas at once.
 2. Large companies do not use construction loans which are costly and troublesome because they can get bank or bond financing.
 3. Buying power allowed them to anticipate rising material costs and negotiate more favorable labor contracts.
- II. Merchant builders have the most volatile results, perhaps because of their high leverage and vulnerability to cost changes.
 - A. Kaufman & Broad had a return on equity of about 30% with equity representing 40% of assets. U. S. Home & Development made 34% but several formerly profitably builders which were taken over by non-construction firms made no money at all.
 - B. Mobile home dealers have little debt but can make as much as 50% on their equity a year and average at least 20%.
 - C. The opportunity for small error in costing causing a significant change in results can be indicated by the following figures:
 1. A builder building 500 houses a year who is off by \$100 per unit has shot \$50,000.
 2. 500 houses at \$20,000 is 10 million in sales but the average after-tax profit margin is 2.3% or \$230,000. A \$100 budgeting error can nick profits by almost 25%.
 - D. The smallest prefabs make the most on equity because they don't have any. For example Techbuilt made 72% on its equity but it had recently undergone receivership and had an equity of 11%. The largest prefab, National Homes, made only 1.1% on its equity.
 - E. The land developers do well if they are in an oil order merchandising or in oil but they do not enjoy the speedy turnover of assets and inventory which characterize builders and mobile home dealers.

1. For example, Skyline Corporation, a mobile home manufacturer, enjoys sales turnover on total assets at 8.03 and a 49% gross on invested capital.
2. Merchant builders on the other hand, such as Kaufman & Broad, have a sales to assets ratio of 1.7 and an inventory of building in process of twice total assets with a gross return on capital at 19% and they are the best. In order to do this Kaufman & Broad makes no investments in land until a lot is needed, matches commitments to sales so that 95% of its houses are sold before completion, uses subcontractors rather than investing in fixed assets, and uses FHA financing to avoid the cycles of conventional finance in California to spite the points that must be paid. K & B's margin on sales is 3.9% so that if FHA points drop from 8 points to 4 points it would double its profit.
3. One interesting device that Cousins Properties is using to avoid construction loans. Preferring to do business with insurance bonding departments rather than mortgage departments because the bond departments are more used to private placements he uses two plans he will take a 15 year bond with an insurance company which does not begin for 5 years. The insurance company agrees to make him the loan 5 years hence and he then pledges this agreement as collateral for up to 5 million dollars worth of 90 and 100 day commercial paper. He sells paper and rolls it over as construction progresses and then anticipates meeting payments on the bond from the income from the projects he has created. In addition he uses joint ventures. As a result he has 5 major projects under way in the eastern United States with a cash investment under \$70,000.
4. Another device developed by Mr. Cousins has been to sell a 6% bond to an insurance company secured by collateral held by a bank trustee. The collateral may be preferred stock or raw land valued at 2/3 of market. Cousins can decide which depending on his land needs. For example, he initially bought preferred stock with the bond proceeds as 85% of the dividends from preferreds are exempt from corporate income tax. When funds for land development is used stocks are sold and surplus land is substituted in the trust.

III. Outside capital form many corporations is also moving into real estate and housing as the big corporations take a look at real estate.

- A. Boise's Cascade was a well known paper and pulp company which decided to capitalize on its forest reserves to move into building components and now into full scale development operation. In 1967 it made 6 major acquisitions with common stock exchanges and potential conversions. The value of these shares was \$107,000,000 at the time of acquisition but at current prices are worth more than \$200,000,000.
- B. In 1967 B-C acquired the second largest mobile home maker, Divco-Wayne, the third largest pre-fab company Kingsbury Homes, two home builders in San Francisco and Los Angeles and three land development companies to make its shelter sales \$172,000,000 a year as opposed to \$123,000,000 reported by Levitt and Sons which merged with IT&T.
- C. However, many other firms had begun to move into real estate development as outlined in your readings, New Capital for Home Building.

1. Some are old stories like Alcoa and General Electric. More significant, however, is the formation of subsidiaries by insurance companies, Penneys, Sears, and Chrysler to build houses to compliment new plants, new stores, or new office complexes.
 2. However, real estate still has a mystique about it to make it difficult to measure yield or risk. Many big companies have built office buildings or other complexes to reflect the ego of the president rather than the decision making of the controller. A show place is not necessarily a profit maker.
- iv. A basic theory of ~~both/and~~ growth stock investment as an industry which produces and sells at a rate faster than the population expands - that is increasing unit sales for capital.
- A. Nevertheless, today we are approaching a housing shortage because unit production is not keeping pace with the number of family units requiring housing.
 - B. The conventional wisdom is that dramatic engineering innovations will eventually provide the consumer with more housing per dollar ~~per~~ of annual expenditure. Nevertheless, on an annual basis the cost of money takes 42¢ of each consumer dollar for shelter, 33¢ for costs related to the building facilities, and 25¢ for costs related to land.
 - C. Therefore, an innovation in consumer home financing may be more significant than an engineering innovation. The average family pays \$1500 a year in rent or in mortgage payments representing an annual expenditure of almost \$100,000,000,000 billion or 1/5 of total personal disposable income.
 - D. The housing industry system is supposed to produce, finance, market, service, and maintain a housing inventory that is supposed to expand as the population grows and adjust to increasing income power and increasing mobility.
 1. If we look at the shelter process over time then one is concerned with not only the new units built each year but with all 60 million existing units of different type, size, age, and quality and price level.
 2. Because each home owner deals for his services as an individual buyer why not create a device by which a single corporation would buy, build, own, rent, and sell interest in real estate. Stanford University research institute has proposed such a service business. A housing corporation and a look at what it proposes to do will at least focus thought on the inefficiencies of banking the present shelter needs of the population. In short, - systematize the flow of money for housing services.

Comments on Roulac Leaseback Case

- I. Single property, specified fund, limited partnership, infra-state offering, registered with California Corporations commissioner.
 1. Secured investments of San Mateo, limited, ~~the general partner~~ is the limited partnership with 224 units of \$5000 each.
 2. Down payment was \$145,000 down plus \$975,000 of prepaid interest.
 3. General partner is American Plan Investment Corporation which receives \$219,000 front end commission, \$25,000 in costs in a 5% subordinated interest.
 4. Seller is a joint venture of the L.B. Nelson Corporation in the American Hawaiian Steamship Company.
 5. Financial devices in one deal include:
 1. A land sale and leaseback to Guardian Life Insurance Company
 2. A first mortgage loan back to Guardian Life Insurance Company on the improvements plus the leasehold interest.
 3. The Baywood Apartment project on the leasehold was then sold to the limited partnership, financed by a wraparound mortgage back to the original joint venture. The joint venture also agree to leaseback and operate the apartment project for ten years. Note that the development group financed construction with the first mortgage to Guardian Life and then made itself the beneficiary of the wraparound to the partnership so it is retailing money from Guardian.
 6. Notice the first clue as to the nature of the inflated price can be found in the cash breakeven point of the project when the nature of the elements concluded is checked. No reserves were provided. Moreover despite accelerated depreciation, income taxes would be due in the first year creating an additional cash drain not usually included in calculation of default point.
 7. Notice that the wraparound mortgage is accelerated by repurchase of the land and in any event presumes early prepayment by 1984. The land purchase option terminates by July 31, 1984, but if the partnership elects to buy the land it must refinance including a 4% prepayment penalty. Should refinancing surplus fall short of liquidating wraparound, the limited partners have only two years to pay off the balance.
- II. The chapter on appraisal sophistry is particularly useful in illustrating the use of faulty assumptions to permit introduction of faulty appraisal methodology. The true issue for the appraiser is what the property would sell for at a base price without unit sales of shares. Note that appraisers have market data approach could not be used because of land leasehold. In addition the appraiser then indicated that the land had no residual value anyway in order to have all value assigned to the overvalued improvements.
 1. On page 45 in a critique of projections, notice that projections never included the impact on liabilities due a sale. Compare this to MR CAP which provides comparison of equity surplus with or without a sale.

2. Note that on page 37 and 38 Roulac explores alternative selling prices and specifically sale as a result of foreclosure.
3. Note on page 74 the cash flow of developer. Many developers would have taken sales to include the total sale price in the year of sale if they wanted to hypo their earnings per share for a stock issue. A good way to see how investor will do, is to estimate how the developer will do on the guaranteed leaseback. A seller may be better off to sell an old building at book value and lease it back to take operating losses then to show a capital loss for which there is no offsetting capital gain or which would produce a write-down in book value.
4. See page 79 for analysis of land lease.
5. The investor should go back to basics by setting up the major dates and events in a project:
 1. Along a time line giving dates of options, notes maturing, mortgages expiring, leases expiring, etc.
 2. Should schedule net required outlays and contract receipts over time.
 3. Should isolate key assumptions as to future mortgage amount, future resale price, or future rental rate on which adequate return depends.

Estate Planning
Impacts on Real Estate Investment Positioning

- I. Basic issues in estate planning for investment real estate involve:
 - A. Formulating personal objectives consistent with:
 1. Operation of state laws of inheritance
 2. Powers of estate administrators
 3. Needs and abilities of heirs
 4. Impact of estate and inheritance taxes
 5. Flexibility for tolerance for changing circumstances at time of death
 - B. Valuation of the estate
 1. Projecting rate of accumulation
 2. Estimating funds required to meet objectives
 3. Anticipating cash requirement for administration and taxes
 - C. Alternatives for minimizing taxable values
 1. Marital deduction
 2. Charitable donation
 3. Prior gifts and gift exemptions
 4. Devices to automatically establish values
 - D. Providing liquidity for the estate
 - E. Reducing administrative costs and time
 1. Transfer devices such as joint ownership, administrative trusts, life insurance proceeds, etc.
 2. Ease of administration, inventory, and disposition
 3. Removal from administrative estate (as opposed to taxable estate which includes constructive ownership)
 - F. Providing ongoing management of business and investment assets and providing for conversion of assets to passive income as appropriate
 - F. Conversion of estate values into divisible ownership units appropriate to nature of bequest
- II. Major revisions in the estate and gift tax laws were made at the beginning of 1977. Lifetime gift transfers and bequests are made cumulative and the tax rate is uniform beyond basic exemption limits of \$30,000 per person or \$60,000 from husband and wife combined.
 - A. Two concepts lead to some confusion - stepped-up basis and carryover basis.
 - B. If the decedent died before 1977, and now before 1983. The new owner enjoyed a basis equal to the market value on the date of death or alternate valuation date. Not only was capital gain tax avoided but the new owner could depreciate on the new basis. A special provision in the 1978 law permits this stepped up basis to operate through Dec. 31, 1979.
 - C. Thereafter beneficiaries will acquire the property under the carry-over rule so that the basis is the same as the adjusted basis immediately before death of the decedent or before the gift.

However, the basis subject to the carryover rule is first adjusted so that total appreciation is added proportionately in terms of the number of days the property was owned prior to Dec. 31, 1976 and following that date prior to death or gift. Additional adjustments in basis can be made for federal and state estate taxes attributable to net appreciation so that the capital gains tax payable by the estate or heir will depend in large part how long the property is held following Dec. 31, 1976. It is this kind of tax law feature which makes exact estimation of liquidity needs so difficult.

- D. The old step-up rule still applies to \$10,000 worth of personal effects or where the aggregate basis of all property is less than \$60,000.
- E. For property acquired by gift, the carry-over rule applied prior to 1977 where the basis was increased by the amount of the gift tax. Since 1977 only that part of the gift tax attributable to the difference between fair market value and the donor's basis is considered. A life estate has a 0 basis for the beneficiary.

Single page second -

Real Estate and Estate Planning

- I. Of all investment media real estate has more emotional content and irrational justification than any other. It is so complex that it is difficult to compare and analyze but it is so elastic in the attributes that can be created for it that it can be tailored for virtually any investment purpose.
 - A. For the typical individual his first decision will be to rent or buy an apartment, or a single family detached home.
 - B. Once a certain amount of liquid savings or emergency funds have been accumulated there is the question of using real estate as an investment media for estate accumulation.
 - C. Assuming some accumulation of wealth real estate provides a flexible vehicle for transfer and distribution which can bypass various estates administration problems.
- II. The housing decision is constrained by ability to pay, preferred life stock, and consequential change in net worth.
 - A. Ability to pay - see housing center notes and:
 1. 20-25% of monthly income. A \$10,000 income suggests a maximum of \$200 a month for housing not including electricity and telephone.
 2. Perhaps 60% of that would be available for mortgage principle and interest and a mortgage insurance premium. Beyond that there are insurance premiums, taxes, maintenance and repairs, heat and water and yard maintenance supplies.
 3. The \$120 a month for an FHA 7% loan with 1/2% premium for 25 years will cost \$7.39 per thousand or a \$16,000 mortgage. With \$2,000 down one might be able to swing an \$18,000 house. (950 sq. ft. house with lot on east side)
 4. The equity buildup as a result of amortization is minimal, less than \$1,000 in the first 5 years. Inflation may improve the equity position 15%, perhaps \$2700. The profit is difficult to realize as sale would cost at least 6%. While 60% of the housing cost would be stabilized the other 40% will have also appreciated, particularly real estate taxes which are rising 7% per year.
 5. The alternative to ownership is rental. For the couple with children a 3-bedroom apartment in a comparable neighborhood to their home purchase preference will cost more than ownership on a monthly basis but net about the same if they expect to move from one community to the next.
 6. A lease does not require a down payment or closing cost nor does it require a brokerage fee to relocate. Certain maintenance costs are fixed when included in the rent and there may be some

LECTURE #5

PRINCIPLES OF ESTATE PLANNING Real Estate Investment 180

- I. Estate planning is more than drafting a will and buying life insurance. It is first concerned with a plan for the accumulation of wealth, and then with ease of transfer and equity of distribution during or after the life of the individual involved.
 - A. Accumulation involves systematic saving and the protection of income not needed for consumption from the heavy inroads of taxation. Real estate is well suited to this process because it provides both certain income tax advantages and systematic saving inherent in the amortization of debt. We have already touched on many of the devices of accumulation such as:
 1. By control of earned income and thereby transfer of one generation to the next job opportunity and security.
 2. Move into heavily mortgaged high leverage investment and transfer low equities to heirs at a gift tax cost. Full values develop in the hands of the next generation as the debt is retired.
 3. Recapitalize assets so that low value assets can be transferred with build up in the next generation
 4. Take family members into business through joint venture, partnership, or family owned company.
 5. Control future liquidity from a present investment such as possible with life insurance
 6. Control risk, management requirement, and time requirements by the nature of investment property and extent of equity interest. For example, a small business may offer rapid build up but create a management risk. Real estate may protract the rate of build-up with different degrees of management required for timber, least building, or citrus growth.
 - B. Today we will be more interested in the effect of transfer and distribution plans on the value of a real estate investment. These valuable may be vulnerable to the following upon the death of the investor:
 1. Loss of profitability due to loss of management
 2. Loss of maximum value due to a need for forced sale to meet problems of liquidity or divisability
 3. Administrator and executor expense (Sliding scale of 9% on the smallest
 4. State inheritance claims scale up to 4.5% on 10million*)
 5. Federal estate tax claims

* In Wisconsin, \$10 a day plus 2% on anything above 20,000 just for executive fees

Inheritance tax in Wisconsin of 2-10% plus 30% sur tax on funds over 500,000 except for a \$15,000 widow exclusion, 2,000 for each child, and 10,000 life insurance for a named beneficiary.

Federal taxes range from 7-77% on a taxable estate in excess of \$60,000. Uncle Sam gets 30% of a quarter-of a million dollar estate where there are no other provisions made.
- II. Growth and leverage possible in real estate can play an important part in estate planning. Take a Grammatic example from Casey:

Lecture #5

- A. Take \$50,000 and invest it in income real estate with a \$100,000 mortgage having an average capitalization rate of 8%. Give this to a child and pay gift tax. If the child invested in bonds at 5% he would receive \$4,000 a year in income while his father would receive something less than \$2,000. If he shifted to real estate at 8% his income would be reduced to about \$16,000, but his equity would build up at a rate of \$5,000 a year, and if rents held up his annual cash income would exceed \$12,000 after payment of the mortgage. With time the gift with its compound accumulation would be worth more than twice as much as a bequest accumulated in his father's estate.
 - B. Investment growth and leverage requires that the individual retain control during his lifetime without having the accumulation absorbed by death costs. Casey recommends incorporation which retain control but gives growth potential to the next generation before it is realized.
 - 1. Issue two kinds of stock; preferred stock equal to actual investment but limited in its participation in earnings and liquidation. Give common stock to the children immediately for it will have little or no value and hence, no gift tax. Growth of earned income is effectively shifted to the children. Voting or non-voting common could also be used where the donor wanted to participate in growth.
 - C. Foreign real estate enjoys a special immunity from federal death taxes, and due to definitions in the code real property situated in Puerto Rico, the Canal Zone and the Virgin Islands would be eligible for the exemption, subject to foreign estate taxes. By reducing the size of the estate you reduce the cash needs for tax payments. There is no advantage from the income tax side and any investment is vulnerable to restrictions on the rate of exchange or repatriation of funds. Currently, Canada has the most appeal except for Ontario and Quebec.
- III. Before elaborating on how to avoid taxes let's review how we define taxable estate, taxes, wills, and other transfers. An estate planning check list provides a outline for discussion:
- A. Formulate Objectives
 - B. Valuation of the Estate
 - C. Estimate and Minimize Values
 - D. Maximize Estate Values
 - E. Provide Liquidity
 - F. Reduce Administration Costs
 - G. Provide Management of Assets
 - H. Convert Net Estate Values into Income and Family Security Terms

The net taxable estate is determined by inventory of the total gross estate and subtraction of total allowable deductions and a \$60,000 specific exemption.

- A. Included in the gross estate are:
 - 1. Real Estate in U.S.
 - 2. Stocks and dividends payable
 - 3. Bonds and accrued interest
 - 4. Mortgages, notes and cash
 - 5. Insurance proceeds payable to the estate or to another in which incidents of ownership remained at time of death
 - 6. Joint/tendency and co-ownership interest
 - 7. Miscellaneous options, rights, patents; and other personal property

LECTURE #5

8. Property transferred in contemplation of death (3 years)
9. Property transferred during lifetime with beneficial interest retained
10. Property subject to a general power of appointment
11. Joint annuity and pension agreements

B. Allowable deductions are:

1. Funeral and Administration Expenses
2. Debts of Decedent and Mortgages and Liens
3. Losses During Administration
4. Marital Deduction
5. Charitable Deduction

C. The Marital deduction consists of and cannot exceed the amount of property which is left outright or with power of appointment to the surviving spouse or 50% of the gross estate adjusted for expenses and claims. The charitable deduction can be applied after the marital deduction to the remaining 50%.

D. Estate tax payable is adjusted for state death taxes paid, gift taxes paid on transfers held in contemplation of death, and for federal estate taxes taxed within the estate of another decedent.

IV. The states have inheritance taxes, 12 states have a state tax, and an additional state tax which means that if the inheritance and/or estate taxes as calculated by the state result in a smaller tax than the credit given by the federal credit form, the state tax is automatically raised to the maximum allowable deduction under the federal form.

V. Property can be transferred at death under four broad techniques:

A. Joint ownership with survivorship rights

1. For income tax each co-owner reports his proportionate share
2. For gift tax transfer of single ownership property to co-ownership usually means a taxable gift, except for husband and wife co-ownership of home, bank account, or U.S. Savings Bonds.
3. For estate tax purposes the entire value of jointly held property including joint bank accounts is included in the decedents gross estate unless the co-owner can prove his contribution .
4. From an estate planning point of view too much property held as joint tenants with right of survivorship is dangerous as it may strip estate of assets automatically by operation of law without leaving cash to pay taxes or flexibility as to the distribution of asset values to meet other bequests or objectives.

B. Property may be transferred by the operation of the laws of intestacy or by will

1. In Wisconsin the equity interest and real estate would descend in equal shares to the children subject to the widow's right of dower to one-third of all lands of which her husband was seized during marriage. In the case of a homestead in which she had an interest she is entitled only to the cash value where there were no children or she had not remarried. (See 233.01, 237.01 and 237.02)
2. If the decedent has no lineal descendants, the property goes to the spouse; if no spouse, to the parents of the intestate, and if these do not survive, to brothers and sisters and their lineal descendants by right of representation. With no survivors property escheats to school fund of the state.

LECTURE #5

- C. Personal property of intestate is distributed the same as in real estate except that the widow ~~receives~~ some share; 50% if there is one child or none, and in any event no less than one-third. Moreover, if any legacy or intestate property is not claimed by the legatee or heir within 120 days a final probate decree it will be converted to cash and escheat to the school fund. This can be modified for foreign heirs or by the probate judge. 318.01
- D. Before final shares are determined the judge may approve payment of all debts, funeral charges and administrative expense. He may grant a widow's allowance with the following priority of distribution: 313.15
 - 1. Allowance to widows including clothes, jewelry, and household furnishings.
 - 2. Allowance to family for widow and children to provide maintenance appropriate to their standing.
 - 3. Children are granted their personal property and property of the estate not to exceed \$200 as selected by their guardian.
 - 4. An additional sum not exceeding \$2,000 for funeral expenses
 - 5. Excess applied to debts
 - 6. Further allowances to minor children as if the father had died intestate
- E. After these allowances are made debts may be paid in this priority: 313.16
 - 1. Funeral expenses
 - 2. Expenses of last illness
 - 3. Debts having preference under the U.S. or state law
 - 4. Three months wages due workman or servants not to exceed \$300.
 - 5. Debts due other creditors

- VI. Obviously from the above property distributed without a will may be quite contrary to the wishes of the deceased. Aside from various administrative details a will may follow one of three basic plans for the transfer of property:
- A. The outright method where everything is left to the spouse, who in turn will leave it to the children
 - B. The strict trust method where his wife receives a life estate in a trust with the corpus to the children
 - C. The marital deduction trust where property is placed in two equal trusts with a life income to the wife for life and the corpus should be distributed at her death. She is given the power of appointment to defeat the remaindermen to one of the trusts should she specifically elect to do so.
 - D. The ^{four}~~three~~ methods produce entirely different death cause. The first method is most costly and saddles the widow with all the problems of management. The second is less expensive and guarantees that the hand of the dead will control the distribution of property upon death of the wife. The third is the cheapest in terms of taxes, but the husband loses assurance that his whole estate would go to the children.

Administrative Living Trusts

- 1. Management during life time
 - 2. Reduces or eliminates cost of administration
 - 3. serves as supplement to will
- E. Short Term Trust - 10 yrs. minimum or death of beneficiary

LECTURE #5

- E. With the following assumptions the taxes under each method would be as follows (giving no allowance to state or inheritance taxes)
1. That the husband's estate will have a value at his death of \$250,000
 2. That his wife has no separate property of her own.
 3. That the estate administration expenses will equal 5 percent
 4. That he will predecease his wife.
 5. That she will survive him by ten years.
 6. That his estate will eventually pass to his children
 7. Outright Method

~~8. Strict Trust Method~~

~~9. Marital Deduction-Trust Method~~

a. At the husband's death	\$21,688
b. At the wife's death	49,185
c. Total charges over both deaths	\$70,873
8. Strict Trust Method	
a. At the husband's death	\$56,450
b. At the wife's death	None
c. Total charges over both deaths	\$56,450
9. Marital Deduction-Trust Method	
a. At the husband's death	\$21,688
b. At the wife's death	9,188
c. Total charges over both deaths	\$30,876

- F. Generally the Marital Deduction Trust is generated from 50% of his estate while the will directs that all taxes and expenses be paid out of the second part of the estate. The residual of this second portion is then used for a second trust.
- 1.. The wife can be included in trust management decisions by making her co-trustee so that her personal preference can be combined with management skills of a trust officer. The creator of the trust may provide certain instructions as to investment policy and the sale or intention of individual assets.
 2. Additional trust flexibility may be introduced by granting the power to invade the principle or the non-cumulative right to withdraw \$5,000 or 5% of the trust for whatever purposes the widow desires.
 3. Assets selected for the marital trust should exclude life insurance on the life, foreign assets and certain other special kinds of property. On the other hand wasting assets such as an annuity should be transferred so that she has a smaller estate to pass on to the children.
- G. The non-marital deduction trust can be broken into several trusts if desired to save on marginal income tax. A trustee may be granted discretion to "sprinkle" trust income among wife, children, and grandchildren as their needs indicate. Ultimate distribution must be specified but postponed until the death of the beneficiary who may be granted a power of appointment.

VIII. Real Estate Investment and Estate Planning

- A. The Problem of Real Estate Valuation. for planning purposes and estimating estate values upon death is further complicated by determining what values would remain in the administrative estate and what values would transfer automatically to co-owners.
- B. The question of estate liquidity raises many questions:
 - 1. How is mortgage affected by death? Is it callable by the lender? Must it be paid from the estate or does the will make possible transfer of real estate to co-owners or heirs subject to mortgages?
 - 2. Is the fiduciary granted power in the will to hold real estate and to finance it or must he pursue his basic responsibility to liquidate assets?
 - 3. Does the real estate generate its own cash needs or will it make demands on other income of the estate? Are there dangers in holding raw land or in cash demands of a project under construction?
- C. What are the management requirements of investment real estate and who will be responsible during probate? Is a business form used to provide continuity of management?
 - 1. Value of an inter vivos trust versus a holding company.
 - 2. Value of property held by partnership versus tenants in common.
 - 3. Should death excuse a lessor from a lease? Should a long term apartment lease include relief should one's spouse die?
- D. How can real estate income and capital adapt to changing needs of beneficiaries
 - 1. Provide for divisibility of income both for present and future needs.
 - 2. Provide for stability of income, invasion of capital, and accumulation?
 - 3. Provide for maintenance of the homestead without taxable income to the life tenant?
- E. The problems of real estate ownership in several states as it affects proof of domicile in one state for probate court jurisdiction and inheritance tax payments.
- F. The impact of death upon establishing tax base
 - 1. Which properties should be locked in to avoid capital gains tax?
 - 2. Which properties might be given a low market value with some sample sales?

Real Estate 850
Lecture 14, March 23, 1987

Bill Morrell, Real Estate Advisor for Alexander Brown

Public pension funds have been behind corporate brother in doing new things.

Roger Meyer got Oregon Public Employees Retirement System interested in investing in real estate in 1978-79 long before other public funds.

Lesson is get entrepreneurial oriented persons on boards.

Alex Brown in Baltimore is involved in REIT's.

Oregon went to Alex Brown for REIT.

Couldn't find one to buy so decided to invest in RE directly.

Developer owns 50% of projects Oregon buys.

In 1985 began program to buy series of REIT's.

Wanted to buy investment that allows them to increase or decrease their share of real estate easily.

Can do that with REIT's.

Marketability and liquidity.

Greater diversification than direct portfolio.

Can get into types of properties that they can't do on their own - community shopping centers, apartments.

Objectives

Want you to buy companies, usually REIT's, where income and capital appreciation that investor receives comes directly from underlying real estate that's owned in portfolios of companies in which we own shares.

Increased cash flow, increased depreciation over time.

Doing it thru REIT vehicle.

Important to consider this a real estate investment.

Makes sense for pension funds, especially small.

Not enough money to buy directly.

Advantages to this type investment.

Assets in R. E. securities fund are marketable securities.

Can increase or decrease allocations to real estate.

Greater flexibility.

Investor gets 3 kinds of diversification.

1. Geographical.
2. By product or project (apartments, shopping centers).
3. Management style.

Since 1978 REITS have performed very well. Some 15 to 20% returns.

Have very high current yields.

Makes them attractive from a common stock investment standpoint.

New tax law puts a great premium on current income.

REITS have to buy properties that are already generating a cash flow.

To maintain dividends.

Slightly less risky part of the market.

Keeps them from making major mistakes.

Have tended to invest in a niche.

Basically 3 to 15 million size.

Not as many players in this market - kept them from markets that were being badly overbid.

REIT's that they're investing in are infinite.

Management has responsibility and willingness to not only improve their existing properties but to add new properties to their portfolio.

Growth occurs.

Most of their REIT's appraise their properties each year.

Have advantage of knowing what properties are worth.

Try to find properties where market price is below appraisal.

Typically REIT's have sold at discount because of bad experience in 70's.

Another impact of new tax law:

Has led a number of very good real estate companies to consider forming REIT as way to get capital for future growth.

Will greatly increase the number of institutional quality REIT's that are out there and make it a better market.

A large number of pension have set up real estate security funds in the last 6 to 8 months.

Biggest is Fidelity Management group in Boston.

Guidelines they use in investing in these types of securities.

Invest in REIT's that allow the fund to benefit from the income and capital depreciation of the underlying real estate.

Concentrate only on those companies with portfolio of existing income producing properties.

Invest in companies with a specific market niche.

Companies with strong regional flavor.

Look for companies with conservative debt equity ratios that can raise additional capital at reasonable rates.

Concentrate on companies that own shopping centers, industrial properties, apartments and nursing homes.

Don't invest in REIT's that make mortgage loans without equity enhancements.

Don't do anything with REIT's that invest in construction loans.

Don't do anything with residential home builders or land development companies.

Monitor dividend coverage ratios. There have been 6 or 8 good REIT's that have cut their dividends. Bad sign.

Long-term real estate oriented investors.

Not afraid to invest in areas which depressed right now.

Have third category of investments - private (placements)

Usually niche oriented

(Kroger) co.

Started suburban office building business in 1950's.

Have 15 or 20 suburban office parks in So-Ea US.

Have 2 companies.

Kroger Properties

Build office buildings

Standard cookie-cutter type

Can keep costs well below competitors

Charge lower rents

Can keep tenants

Kroger Company

Buys the completed building once it reaches 90 or 95% occupancy.

Kroger Appreciation Notes

Give you a 9% coupon each year

Give you another percent equal to percent which selected properties have increased in value from one year to the next.

They take shares in Kroger Co. instead of additional interest.

Participating mortgage (Graaskamp)

At one time designed to be variable interest note.

Now being used as a back-handed equity because pension funds feel better being a creditor than being an owner.

They initially did convertible mortgages w/Oregon

Switched over to participating because better position

Participating mortgage did extremely well up until interest rates started to drop.

Market was dead for about 8-12 months.

No developer/owner wanted to do participating mortgage when he could get straight debt at 100 basis points higher than participating mortgage and not give up any equity interest.

With new tax law they've come back.

It's hard to find equity sources now.

A way for developer/owner to cash out, get 100% of his financing and get a lower interest rate.

Rates have changed dramatically.

Coupon rate could be only 8 or 8-1/2...

Tape flipped.

Also gives them an owner/developer who's in the project with them with his entrepreneurial skills, will make it a better project because he has a percent of the deal.

REIT not only public instrument but a rather neat private placements financing device.

Several funds out designed primarily for a selected investor.

Structured as REIT's because it makes neat corporate package.

You get a full conduit pass-thru at a time when the investors may have different tax status.

Example: Pension fund can be in leverage real estate but University Endowment cannot have investment in leverage real estate where the leverage exceeds the basis on the property - called unrelated business income, becomes taxable. REIT solves that problem in that only shares in the trust which are not leveraged and therefore they do not have unrelated business income as compared limited partnership type of venture in which the characteristics of the asset pass thru to the investor.

Some versions have split underwriting in which majority go to tax exempt and the rest to private investor.

He's taxed at his point of ownership.

May pay a small premium for his share.

There's a market made in the shares so pension plan can sell their shares at a future point.

In the meantime they buy at less than the private investor.

Get much more scale to the real estate trust than they've traditionally been able to get.

Hybrid trusts in terms of marketing of their shares because taxable character falls on each individual investor.

Interesting article out presently as whether real estate investment trusts provide the same kind of co-variants to the stock market as real estate asset does.

Initial evidence is trust shares tend to behave more like stock than like a real asset.

Some are arguing that you lose the co-variant aspects of real estate for diversification.

Finite real estate trust may permit the trust to behave more like real estate in the marketplace and less like stocks.

In the past the rap on real estate trusts has been the price has never reflected correctly the underlying asset.

No way for investor to know what asset was worth.

Booked the asset at purchase price and took advantage of every bit of accelerated depreciation to keep as much income within the trust as possible so book value steadily declining.

No way of looking at the book to figure out where they're at and what should the book value be relative to the market value of the share.

Most did not report appraised value annually for the underlying asset.

Therefore market price slipped. Became an income security.

People are now looking for ways to see if the real estate trust can be created in such a way that it has the attributes of the underlying real estate in terms of its investment co-variant relationships to other kinds of securities.

Private REITS very useful local device.

Often goes together w/development company.

Very useful for financing development.

University Physicians

Own their own building with private trust

Each Jan. 31st doctors leaving sell and those coming in buy.

Earnings are well tax-sheltered.

Doctors get increments over their fees.

Real estate very useful for this.

Alternative is master limited partnership.

Has appropriate characteristics.

Stronger conduit than the trust.

High target for IRS tax reform.

Tremendous accounting complexity.

BUSINESS 850
LECTURE 1-20-88

Real estate is simply a statement of Hope; it is based on Hope and is ironic, because we are making a premise of a 10-30 year investment. It presumes social, cultural, and technical activities will move forward at such a pace that there will be enough time to change, improvise, and enough opportunity for creative advancement. It is a commitment on Faith and then rationalized.

Real estate is based on the Future, -futuristic, extrapolations from what we think we know. We move from irrational Hope to rationalized attitudes and come up with an intellectual strategy. It is a basic dichotomy: real estate as assumptions about the future vs our ability to adjust in the present and survive in a changing world.

Real estate is a long term view, with leaping assumptions about the future. Helping the dichotomy is the question: How long is the time line of the Hope? In trying to get a handle on Hope and structuring it into a rational attitude, how often are we affected by topical (ie. investing against the tide-contrarian position against short term beliefs) short term attitudes? Pension funds can be more patient than the need to buy food and clothing from the sale as with the individual. Thus there is the time line of a pension fund vs that of the home buyer.

British pension investment strategy(article): invest just before the country flips into socialism, because then you will have a monopoly since there will be no more entrepreneurial incentive to create supply. America is moving into an era of socialism--this is not a topical issue, but an investment strategy.

Observe current attitudes. We are going to run out of oil... by the year 2000 gas will be \$2.50 a gallon. We need a responsible energy program. Thus, suburban and regional center are not the best idea: neighborhood shopping centers which we can walk or bike to must be included in an investment strategy of a pension fund 20 years from now.

Electricity--atomically generated: the life cycle cost of atomic plants are negative; it costs more to run and build it than the power is worth--maybe they will be replaced or shut down.

If real estate is futuristic, what is your premise about the future and how far out are you taking that premise?

Elderly Housing--40 years from now no one will be there; all young people are moving out. Alma is dying. How will the mortgage be paid? Housing Policy--(under Section 8) mostly elderly, permitted to live at 30% of their income; under contracts that expire in 6-8 years and will probably phase out in 12. There is no government policy as yet to deal with all of the homeless that will result. But investor expectations downstream--perhaps that under Section 8 the govt. will come out and rent the space which exceeds the elderly's income. Who is wrong?

Real estate is based on extrapolating cash flows and taking them forward in a vacuum; not looking at the anticipated context 5-10 years downstream. What is the Hope of the guys going in?

The profession real estate operator works by a series of short runs because he bases it on Fees managing, building, securitizing, brokering the project, syndicating, leasing. The real pro doesn't own anything: he structures the deals so that if for some reason unforeseen to him something occurs, he can share on the upside with a participation %, otherwise he can take a walk. The individual equity investor doesn't have a true sense of what he is doing.

Real estate is tied to future Money Markets, in a macro context--not just a micro. If Tokyo and Bonn don't like the next president, they don't have to support the treasury rate--and interest rates will move before the '88 election--and a recession will start before the election, in which case the Republicans would be dead. Saloman Bros. predicts interest rates will be 11-11.5% by the 3rd quarter of '88--note the impact on the resale of real estate.

And does the political agency have much to say anymore about interest rates? We have a trade deficit whereby people own your butt, and a federal deficit whereby people who buy your bonds own your butt. And real estate interest rates will be a function of these and + a considerable loading.

The debt cover ratio, instead of the loan to value ratio, is determining what you can pay for a project...Resulting in the need for more equity, less debt.

Liquidity is the objective of any enterprise to cover operating expenses(Drucker's article). Liquidity need of each enterprise increases each year; need more and more liquid to cover costs. It gives you the flexibility to survive.

Builders lost last time because they were carrying inventory in land and unfinished tenant space. Dump it now and take options on land 2 years from now--the recession will begin by 88-89, no one will be buying houses--the land will sink you, get rid of it.

We tend to use goals and ratios that may not be relevant to our Hopes or future reality.

Real estate investment is passive and long term. Development is the exploitation of the short term.--exploitation of a short term opportunity and a spread.

The essential strategy is to improve your spread by A) enhancing the monopoly characteristics of the property and thus enhance revenues; or, B) Reduce costs including the cost of funds.

Active investors ie. developers create spread through opportunism at the Micro level: buy low sell high; insider information is very important.

Passive investors enhance the spread because of timing and the ability to arbitrage typically between money markets and also skill levels. Example. Olympia and York takeover(speculation on a commodity of sq. ft. of office space. He needs to manage it well, but enhances it because he can operate on a timing basis--buy low sell high; but he can arbitrage by reaching money markets that others can't reach, ie. current CMOs--the individual pays at retail of 10.5% on his mortgage, but the guy who buys the whole portfolio goes into the money market and bets against the treasury curve and gets an interest rate of 6.5% + 1% credit enhancement = a cost of funds of 7.5%. Take the present value of this and it works out real well.

He is arbitraging as a passive investor--never sees a single mortgage or house.

The essence of a strategy and tactics in real estate, for both the active and passive investor is to exploit the institutional and technical details at the appropriate time in order to achieve a spread. Example: Shidler is a consummate artist of operating within the guidelines of FASB rules and creating illusionary profits for corporations.

One of the problems with active and passive investors is that the relationship to real estate creates an EMOTIONAL factor; they are not always rational. Psychic income is important and probably accounts for 1% on the cap rate--because you can show your pride in real estate.

795 lecture

**Late FEB or early March: Jerry Clays, JMB: Cadillac
-Fairview deal**

March 25: Todd Mansfield & Bill Rinnell, Disney Development
April 8: Jay Shidler
April 29: Steve Jarkow, REIT formation and Lincoln Properties

Comments on the Futurism of Energy, Social/Political trends,--from the Economist: Entrepreneurship, Hope, and Strategy: possibilities of the future(in the articles). Sternlieb's view of cities as the home of the transfer payment--citizens are moving out and employers will follow.

Strategies of real estate for the long term: suggests an infinite degree of investment attitudes based on your hopes about the future-----This is what the entire first part of the lecture addresses.

Part two of the lecture addresses the economic scenarios about the future; add up the scenarios and **Establish the premise from which you operate.**

Scenario #1. Most industrialism in the US will go into a smooth transition into a new economic role with less significance in the world and will resolve social problems; there will be steady economic growth with a few brief recessions, gradually declining Unemployment, and a decline in manufacturing moving toward a service economy. Lower interest rates into the millenium.

Scenario #2: Erratic transition, interrupted by recessions the like of the 1970's; economic growth is sporadic with stagnations and negative growth; aggregate unemployment will range from 7-12% and there will be regional pockets of unemployment, even pockets of rebellion in areas not getting their fair share of economic opportunity; debt loads remain high and there are increasing defaults; there will be considerable rescheduling of payments to protect the credibility of our financial institutions---\$25-50 billion losses in S&Ls, but we can't afford to close some because FSLDIC is bankrupt; the problem is less severe with banks because they don't need to report losses, the statement doesn't need to reflect underlying value of the asset, but instead can be the amount of the note. Also, pressures to control deficits will cause increased taxes and severe spending adjustments.

Where are the hot areas. New England because more defense spending goes there than anywhere in the US. If cuts in the budget to defense, then what? Plus, they also have Senators in key positions on important boards.

Will real estate moderate gradually?--Will deflationary forces from the decline of excess capacity and higher debt loads keep pressure on borrowers?

And what of the trade deficit? If interest rates fall, less foreign capital comes here...this scenario is not necessarily good for real estate.--As the dollar falls some jobs will come home. Example: Tandy saw cheaper labor in the south than in Korea; but it comes back to non-unionized, non-structured labor pools that can be exploited--look at the new Immigration law's effect if enforced in 1988 not enough help to pick cabbages or to work in your plant---All things work together.

Scenario #3: Economic disruptions; high defaults on foreign and domestic loans; the deficit will never get under control and we will need drastic control measures; rising unemployment in the areas of defense and manufacturing and spreading to other industries; real estate interest rates will stay high in the 80s: A) reflective of legislation and; B) to protect us from a run on the dollar by overseas money.

Scenario #4: Social disruption in cities where now 25% of the population is in poverty and getting restless.

Whichever scenario you take should influence your view of real estate. Put into action in the form of Development(exploit the opportunity of Active investment) or Investment(use diversification because we don't know where lightning will hit next).

To what degree is systematic risk carrying more significance than non-systemmatic in that it can be relatively easily stabilized?

Thus, with real estate investment, we must make a mushy set of assumptions about the future context we are operating in and having a hope about the future, otherwise we will go into CDs and Treasury Bonds.

What is the hope and framework in which we build a rationalized, systematic method of selection and management?

Our Method, Strategy has 2 characteristics:

- increase Spendable income
- increase Net Worth so that we can pass it on to the next generation

(Reagan has allowed the middle class to pass on net worth by raising the exemption from the federal estate tax so to pass it with marginal liquidity exposure.

RE as an Equity Investment - GRAASKAMP

file name: notes850

tape: 1A1

25 Jan 1988

R.Est. is based on hope

Hierarchy of concerns: 7

- 1 pol. exposure
- 2 the degree of mkt monopoly
- 3 deg. of mgmt intensiveness
- 4 economic/financial aspect of the enterprise
- 5 decision pts that allow for an abrupt exit
(length of the committment)
- 6 Fed and st. inc. tax attributes
- 7 "fit" of the RE to the estate or distribution plan

In detail:

- 1 Pol expos. : 3 forms
 - a changing land use patterns developers ask when am I vested? (protected from land use changes)
 - b subsidy to the competition (TIF, catastrophe financing from gvt., sect 8 housing etc..)
 - c Flip side - what if your proj is subsidized and the subs. ends?
IE; is gvt subsidizing supply or demand?
- 2 Degree of Mkt monopoly : object is to create a customer- 4 ways
 - a direct control of that customer: my bank, my bldg, my loan, you'll lease here.
 - b reciprocity: bank would lease the space at a big discount to its good customers.
 - c channeled demand: physical geological constraints ie: San Fran., Marthas Vinyard
channeled as far as infrastructure, utilities among others. Synonym; monopoly
 - d Mkt Research - identify the mkt through research

NOTICE THE NEED TO OPERATE IN A MONOPOLISTIC ENVIRONMENT. THERE IS CHRONIC OVERSUPPLY IN ALL FORMS OF R.E. THUS THE NEED FOR SOME TYPE OF CUSTOMER CONTROL.

- 3 degree of mgt intensity: stability or unstability of enterprise depends on mgt to a high degree.
Get around this thru tripple net lease back
making mgt highly mechanized & thus highly replaceable
(Western Sizzlin vs. gourmet)
- 4 Financial/economic (notice how far down the list)
what profit ctrs are appropriate for this investor? REIT, RELP, passive, active? land, devlpmt, leasing, mgmt., which can we do & which must be farmed out.
Also, what time frame for investment, concerning estimates of expense, revenue, and a risk mgmt device to control the variance bet. the two.
 - a control the variance thru: leases, nonrecourse financing (if project fails, turn it back to the lender w/o liability), master leases (guarantee a min rev line)
 - b measures of variance: Cash Break Even Pt.

4b (cnt'd) to what deg. fixed cost vbl expense? the
greater it is the more critical it is that
you create a monopoly for your R.E.
c measures of risk and variance; diff. for each proj.

- 5 decision pts.: At what pt. on time line can/should you bail
out.
can you structure the deal so that you have a min sunk cost
throughout?
Skillful procrastination: taking time to pick the best
path through the proj, study all aspects. Retain con-
trol but not have to make up your mind right away!

6 Tax

7 Estate Plans To be discussed later

Continuation of The Hierarchy of Concerns (there are 7. Here we'll continue with the last 2 - Taxes and Estates)

6. Taxes : Fed and St. Short term and long term
- a. short term - to minimize or avoid paying
 - b. long term - crossover point #1= when tax depreciation is no longer sufficient to cover the principal pmts due
 - c. Crossover Pt. #2 = when the tax on resale exceeds the net cashover available from the sale price. (project doing well; you refinance; new loan exceeds the old basis; when time to sell, the tot tax bet sales pr. and now depreciated basis exceeds the tot net realizable gain from sale).
Ask can I net enough on resale to be ahead or at least break even?

AVOID THE CROSSOVER TAX TRAPS

- d. Ploys available :
 - 1. postponement
 - 2. leveling of the income to take advantage of the progressive tax rates
 - 3. shifting of the inc. to lower tax entities
 - 4. avoidance : sale of home after 59 1/2 \$125000 freebee
7. Estate or Distribution plan
- a. individuals - when you die granted a stepped up basis don't have to pay capital gains on the estate (the duplex you passed down to heirs begins new basis at current value & you can start redepreciating it at that level)

Tax and estate plans are complicated by the valuation of the project. Valuation window opens at date of death til 6 mos. later. The lowest value applies. This mitigates possible market crashes like 1939.

This is expensive process. You should know pre mortum the values especially so as not to fall into "crossover trap #2"

Continuity. Plan for the efficient transferral of your holdings. you control it not events. Individuals and corporations as well. (to understand the corp. is to know who the stock holders are. Gen partners who do not plan for their demise could force an early and unwanted (hi tax) liquidation of the partnership.

I. To succeed be creative, have a sense of cost controls, and understand gvt regs

II. Investment mkt has gone thru diff stages (fads)

- A. Finance driven - take advantage of spread in real/nominal int. long term loans, 3rd party fin leverage
Not a pure RE invest. rather a play (futures) on money
- B. Tax driven - make \$ by losing \$ as long as cash loss/yr was less than tax savings to other inc.
- C. Fee driven - professionals milking a project by excessive fees
- D. Subsidy driven

These are not investments they are plays

III. Two rational factors make it an investment excluding psychic inc)

- 1. increase spendable cash
- 2. " liquidating val. of net worth
- A. the above fads might play a part but are not the essence

IV. Classical appraisal theory assumes

- A. NOI was constant or would fall along a predictable line and you could simply divide this by a cap rate that included:
 - 1. constant return on capital
 - 2. a recapture of capital
 - 3. that inc was an instant inv. call broker, buy mall, done.
 - 4. Fixed pt of time in which you exited the investment
 - 5. you held investment for its entire useful life.
- B. this was asset mgmt. was the simple NPV positive. If so the invest. was good, justified.
the capital asset pricing model

V. Next came Ellwood. He bought the above assumptions except #5 could sell, refinance, or some modification of position 5 to 10 yr forecast is more realistic and therefore figure on getting most of the capital back from resale vice income. De-emphasize recapture factor in the cap rate because of inflation nowadays there might be a negative recapture factor - more capital back on resale than we put into deal in 1st place.

Recognized that diff sources of capital have diff costs
" " there were assorted equity interests too
and each interest has its own perception of risk thus
its own capital asset pr. model

View RE not as an inc. prod. asset but as a manipulation of liabilities

VI. Next school: Change in Net Worth, Change in Spendable Cash
Traditional assumptions are abandoned.

- A. You trickle in and clamber out of investment
- B. Income no longer on a predictable mathematical line
 - 1. Many of the equity positions don't get their gains from NOI phase but from the expense phase: construction co., leasing co., insurance co., etc. taking profits in the process of getting the property ready for NOI
 - 2. Lease structures which grant the first 5 yrs free in order to compete for the tenants

C. the only way to account for all this is through tracking spendable cash

Accountants are going towards economic prod., asset mgmt., & msmt. The RE fraternity is moving towards cash mgmt. The conflict comes when you must value the proj.. If in fact concessions were made and the tenant doesn't pay (or pays at a reduced rate) for the first few periods the proj. can not be valued by NOI cap rates; the traditional way.

It boils down to the issue (perception) of solvency measured by income, or, Net worth the measure of values vs. liabilities. The banks in Texas are solvent but have negative net worths!

Cash. The P.V. of distributable cash to account for irregularities in the income line.

Determine how often will you distribute the cash.

Very difficult to measure performance in RE because of its long term nature and periodic interruptions in the revenue line. Valuation is not day to day process.

I. Cash flow models calculated with greater detail

A. Expected receipt

- 1 base rent : In gap account. can be bad. eg: no cash flow for 1st 3 of 5 years (\$10/yr contract , 18.50/yr for last 2 yrs). I.E. continued invest but negative cash flow.
PRO: known contractual income stream
can be sculptured to fit tenant needs
- 2 index to base rent (annual adjustment)
Converts base rent to step rent. usually steps up but can go down.
good for investoe - inflation fighter
bad for tenant could hamper ability to pay the rent.
maybe he'll go broke, not renew, or break lease
careful win win must be structured
- 3 percentage rent % of sales. Tells investor what kind of property and its risk factors. High sales tenant high marginal participation. LOW SALES VOLUME could mean opportunity for investor to buy off the tenant's remaining lease terms.

DON'T JUST LOOK AT \$ AMOUNT, BUT ALSO WHAT DO THEY TELL YOU ABOUT THE TENANT AND YOUR RISK!

- 4 Amortized tenant improvement : Upon sale, the large imp's made to get the tenant in may not have been fully amortized. Seller should not forget to discount this upon sale.
If tenant makes improvements himself, he's got a vested interest. It is a sign of a quality tenant.
ten. imp. clauses tell a story. Good for risk averse long termers. Bad if not ammort. & you sell early. & ten. sweat equity can be good too!
- 5 CAM : Common area maint. All areas come under cam - i interior and exterior areas. These fees typically give mgmt a 15 or 20% profit margin. THE INVESTOR SHOULD TAKE CARE NOT TO LET THIS CASH RESERVE FALL INTO THE CAPITALIZATION PROCESS. This profit center is a service component, and should not be bought at the same discount as the real est..
- 6 Reimbursables (annual pass thru) outlay by mgmt/owners recovered over time. in the interim you lose interest.
- 7 Escalators with a stop good or bad depending where the stop is (how high) owner pays up to a certain amt, then tenant kicks in. Was tax stop indexed on 1st yr when none of the improvements showed up in the assesment? (annual review)
- 8 interest on reserves (quarterly sweep) Often times required by law (FHA) or by lender. How much, should be closely examined. reserve, sinking fund, there to protect the mortgage. Sellers will often try to hide these funds which can be substantial if project has been around a long

time, then at closing add them to the sale price without having to capitalize them as part of the project. The interest on the reserves can be part of the income flow.

9 GVT transfer pmts EG the TIF funds can be included in the income stream, or guarantees by the small bus admin.

10 Total receipts Value hidden in the leases that might be purchased or sold.

II. Loss or potential receipts

1. Vacancy loss: not only reflect the loss of base rent but but also reimbursements. Owners try to get tenant to cover the CAM fees lost so that 100% is still covered by the tenants. Sharp tenants refuse to cover more than typical V.R.'s for that type of bldg.

- Concession losses can often be greater than V.L. Tenant improvements, lower rent, all to compete for tenants in an overbuilt mky.

2. Rent Collection losses: stem from the nature of the tenants. Do they have the net worth or the inclination to continue to pay. [Houston firms left behind broke corporate shells and broken, uncollectable leases.

3. Reimbursement collection losses:

4. Receivables: Hinge on tenants willingness and ability to pay as well as the owners ability to collect.

ANALYZE ALL POTENTIAL LOSSES FROM RECEIPTS TO ARRIVE AT REALISTIC REVENUE FROM OPS.

III. Actual revenues for operations

IV. Gross outlays for operations (should NEVER be "netted out")

1. CAM I

2. reimbursables I Note time delays ie. not netted

3. escalator items I

4. owners costs: Ask "what is the entity that I am evaluating"

a. real est proper b. partnership or corporate psit

c. entity which owns an equitable psit. in the R.E.

The RE has 1 set of costs and the Ownership has a 2nd set.

Mgmt fees Vs liability, insurance costs. Each of A,B&C above have their own degrees of these costs. Asset mgr fees might take another .1%.

ASK WHETHER YOU ARE EVALUATING THE R.E., THE PARTNERSHIP, OR THE PERFORMANCE OF THE CO-MINGLED FUND THAT OWNS THE PARTNERSHIP

5 refurbishments Too much implies shoddy const.
6. renewal tenant imps
7. renewal lease commissions
TOTAL OPERATING OUTLAYS

PROPERTY MGMT RESPONSIBLE FOR TODAYS CONTRACTS
 ASSET MGMT " " TOMORROWS CONTRACTS

V. Total Cash From Operations

VI. Capital charges
1. interest pmts not necess. defined by ammortizing st. line
2. principal pmts reduced interest pmts. Sculptured financing.
3. capital imps.

VII. Net Cash from Ops before Taxes

+ transfers from cash reserves from previous period (in antici-
 pation of expenses from some of the above)
 + net inc. in loan bal. outstanding (renegotiated terms, inc
 rents

VIII. Cash Avail. for Dist. &/or taxes

1. taxes: fed. and state and, as req'd, assessments on prop.
 such as Disney and surrounding hotels.
2. reserves retained in the enterprise before distributions.
 such as requirement by contract to dist some funds to
 the community.

The investor is interested in a model which can handle the dynamic nature of all these in, outputs. Needs quarterly, semi, or annual.

Dollar amts are ok but ratios are a better toll for analysis.
 Which ratios? Risk and Return. Yield often thought of as a function of risk but an anomaly of R Est. is that Y is a function of the OPPOSITE of risk (the < the R, the > the Y).

Risk catagories: variance in: spendable cash
 liquidating vakuue of NET worth
 Also look at relative risk/yield of R.E. Vs. other investments
 Measures of yield. prospective and retrospective.

Retro: IRR, etc.. After all is said and done what is my rate of return. Most often type referred to.

Pro: How will I do if I continue to stay with the project for 1 more period? How long will it take me to move in and out?

1. Cash on cash - classic example of Pro.
 FOR cn equity (dn. pmt)

2. cash on sales proceeds avail. at the end of the
previpos calculates opportunity cost of staying in the

3. Portfolio effect: $\frac{\text{Net search cost to find replacement}}{\text{Net premium for selling the portfolio}}$
you want this ratio to be < 1

Ergo: portfolio avg's 9.5% cap rate but the whole portfolio
is worth more to the big investor so he pays a premium for
the package deal, like maybe 8.7% cap rate.

This spread is another type of prospective ror.

R.E. investment the profit is made at the purchase.

R.E. speculation, the profit is made upon the sale.

Options for owning realty by individuals include: 1. sole proprietorship, 2. general partnership, 3. limited partnership unit, 4. joint venture.

A "joint venture" for individuals we're talking about is a ground lease of some form or a master lease, a ground lease being a vacant site which someone else is going to develop & for which the individual receives rent & possibly some participation of the revenues of the improvements; a master lease suggests a property perhaps improved at another time (e.g. 30 or 40 yrs ago) & the family doesn't have the money to improve it, reposition it, market it & manage it, so they master lease it off to a developer who has 40-50 yrs. of ownership of the structure & can best improve the property, with the individual still getting the rent with some kind of kicker in it, maybe indexed with some small participation, but generally the master leasee creates the value & budget for improvements so he takes most of the profits.

These are the 2 types of "joint ventures" that an individual can do, i.e. small scale enough & distinct from some major project that the "heavy players" might do.

The individual can invest in 5. a real estate investment trust (REIT), 6. he can invest in a subchapter-S corp. (notice all of these up to this point are single-conduit entities); finally, the double-tax entity, i.e. 7. the small, family-held corp., can be the ownership entity.

We are ruling out for the moment types of securitization that might involve participation in a CMO or something of that sort, suggesting these are more financial instruments than they are real estate. We're also ruling out for the moment an investment in a publicly traded stock, although that would obviously be an alternative, i.e. you could go invest in Rouse or Northern Pacific or Disney (a fairly good-sized real estate operation). We're treating this as a stock market play as opposed to an ownership of real estate play.

Now what are the attributes? 1. First is scale, "What can I do with \$10,000?", "How big a chip do I have to play with, and how much am I wise to put into a single entity?" 2. The second thing is control. 3. The third is intensity of management (distinct from control).

For instance, I might want to use a master limited partnership in which what the city was going to do with the property was well spelled out, e.g. the family doesn't want the exterior of the building changed because of the historical significance. This could be written into the limited partnership agreement beforehand, whereby an investor can exercise some control, as opposed to a REIT where you put your money in and "shut up". Once a limited partnership is underway you have 3 options: 1. vote with the rest of the limited partners to displace the general partner for malfeasance, 2. vote when you're gonna refinance, & 3. vote when you're gonna dissolve; otherwise you "shut up" because if you do more you're a general partner & become fully liable. The distinction here is between degree of control (in terms of overall strategy) and intensity of ongoing operational management. The master limited partnership provides no intensity of management, i.e. you might as well go to Florida & hope for the best.

3. Next, we're concerned with liability. Under liability I would put 2 items: 1. liability on debt & 2. liability on 1st party torts.

4. The next is the standpoint of risk, i.e. the variance in our financial results relative to our financial plan.

5. The last major item is: ease of transfer by gift or by inheritance. Owning a building outright as a sole proprietorship means you have an appraisal problem immediately; you have the possible gap in management of the property & a problem with the administrator in your will who is permitted to retain ownership & operate the real estate without incurring liability to the estate. With a REIT share there's a nice clean valuation on the date you died, i.e. just look it up in the paper, and if you work it through as an off-shore trust or something of that sort there's no estate or transfer tax (on a gift) at all.

6. One other attribute you might add: degree of anonymity, e.g. you're working for Coldwell Banker and can't own real property (because of potential conflicts of interest), so you need to find a way to hold real estate anonymously. If you're from overseas & your gov't won't allow you to take the money out, you may want to conceal who you are from your gov't & conceal the fact you're foreign from the U.S. gov't.

Now, you can mix & match these attributes against all those property holding types, & an individual investor can begin to put together a strategy on how he's going to go about investing in a real estate "hard asset".

(story about Disneyland)

Question) "Where do tax considerations come in in defining the attributes vs. ownership of real estate?" (answer) "There are probably no tax savings to be had other than the estate tax; however you structure it there may be minor variations between the corp. & individual tax rate but as soon as you decide to go the individual route rather than the corp. route, you've lost your anonymity for one thing, & complicated your estate problems. One suspects that if we ever get an honest President the distinction between these 2 tax rates won't differ, since the 34% vs. 28% tax rate really isn't a true statement of the differential because the individual & the corp. can bury so many things, e.g. 25% of your net income can go into a profit sharing plan that isn't taxed at all, which you can use to invest in more real estate with; you can be the sole trustee of your own pension fund with a corp., so at that point we're saying the rate of the corp. is less, so it's a lot lower than the individual rate; and in addition you can buy your medical insurance and rent a care and a variety of other things, the tax ratio really isn't significant, it's the base line & how much you can monkey with it that counts. Otherwise, you can put tax rate on the list (of attributes), but the tax game has pretty well fallen out except for the "value-in" proposition - so what do you "value-in"? With stepped-up basis you pay no capital gains tax & you start the depreciation game all over again."

Now let's talk about the tax law. Given the format by which you choose to invest, obviously you want to structure it in such a way that: 1. you acquire it with an audit trail that supports your basic strategy, so let's talk about planning your anticipated tax strategy in the acquisition process.

While you operate the property you also have certain elections to make, i.e. what's expensed, what's capitalized, etc.

And then when it comes time to dispose of the property, again there are disposition plays that can mitigate to some degree the overall tax debt. Many of these games have changed significantly with the new tax law & I have handed out to you the hierarchy of critical decisions in the process of acquisition, operation & disposition.

One basic element that's relevant on what the individual can do is that the tax law has completely flipped its perspective, & while it was favorable to the well-to-do & rich, today's law is definitely biased in terms of the small investor.

The application here is Part 4 of what I've taken out of some seminar notes prepared for something else, "Think Small", i.e. the real estate investor with \$125,000 of active income or less. The double taxation of small corps. isn't too serious, but there's a 15% tax rate on the 1st \$75,000 of small corp. income, which isn't a bad thing, as an individual can create a corporate holding vehicle for his duplexes & rental property & with adroit handling of the pension fund, his leased car and a few other things can bring that net income down below \$75,000.

The at risk rules require a general partnership with no more than 10 partners, so a large equity investor may prefer the general partnership form. Real estate as a family business with material participation may still take a relatively desirable tax shelter position, so the basic law is certainly oriented towards the small investor.

The outline here is essentially that there are 3 buckets worth of income under the new tax law: 1. passive activity - has to do with all rental real estate, limited partnerships & all businesses where the taxpayer does not materially participate - "materially participate" - is fairly narrowly defined - a general partner by assumption has regular, continuous & substantial involvement, hence the real estate is a general partnership.

With respect to real estate, dealers are determined to materially participate, & therefore at one time it was bad to be "a dealer" - today it may be a useful device if you have more income in the passive category than otherwise.

The general rule is that net losses from passive activity are not allowed as a reduction to other income; the exception is that the small income, active rental owner is allowed a \$25,000 active rental property loss; you have to have a significant & bona fide involvement in the property & have to own more than 10% of the property (i.e. less than 10 people must be in the partnership) and the active rental property loss is phased out between \$100K & \$150K, so as your income goes up your ability to allow tax losses to slop over & shelter gradually evaporates.

Determining if there is a passive loss limitation: 1. determine the net "active" (i.e. the above-stated exception for bona fide involvement of owners with more than 10% interests) real estate rental activity; if the net amount is a loss, the AGI limitation is applied (i.e. loss allowance for taxpayers having less than \$100,000 adjusted gross income/phase-out between \$100,000 & \$150,000); if the net amount is income it's combined with other passive activity income. 2. determine the net other passive activity: if it's a loss the loss is not allowed, except for the phase-in rules (65% in '87, 40% in '88, 20% in '89, 10% in '90 & 0% thereafter), but can be carried over to other tax yrs; if the net amount is income it's taxable. Passive activities engaged-in after the date of enactment do not qualify for the phase-in rules. Nondeductible passive losses carry forward until passive income absorbs them or the activity is disposed. If you have an unused portion of passive loss you can apply it against the capital gain on sale to compute the base for capital gain.

Bucket #2 is portfolio activity - interest, dividends and gains & losses from portfolio assets and ground lease rent. (It was kind of clever of Congress to include ground lease rent, because otherwise you could have converted a good deal of your real estate rental income to ground lease income and thereby have enough passive income - from ground leases - to soak up the tax shelter you might have had from the real estate rental activity - passive activity. There is still a push from realtors to get ground lease rent re-classified as passive income, in which case you could then have essentially a tax bond, because the shelter on the building which might be 20 to 1 relative to the value on the land would be more than sufficient to cover the rent on the land.

Everything else falls into bucket #3, i.e. earnings.

To decide whether it's tax deductible, there's a 4 hurdle screen:

1. First there are the "at risk" rules. This disallows the interest deduction from any loans from related parties, sellers or persons receiving contingent fees. That was one of the favorite games in partnerships, i.e. to invent a series of fees for the seller, i.e. a consulting, property inspection, etc. fee, all deductible for the buyer as a 1st yr expense that allowed you to hike the tax shelter in the 1st yr. All that's gone - there is a provision that says a related party can make the loan & qualify for the interest deduction, but it has to meet all criteria of an arm's-length loan, with the burden on the borrower (it's difficult to get).

You can have non-recourse financing only as long as it's obtained from a legitimate, 3rd-party institutional lender in the business of making loans. It makes a fairly narrow window for full deductibility of interest and full-deductibility of appreciation on the property.

What happens if you don't meet the at-risk rules? 1. There's a cap on how much shelter the individual owner can take - limited to the maximum amount at risk. It was striking directly at the ability of syndicators to artificially structure excessively high prices by providing less-than-market rates of interest on wrap-around loans provided by the seller; that exaggerated the tax base for depreciation purposes & often meant that all the income went to the seller with the buyer simply getting the shelter. And if you structured that right on a nonrecourse basis the buyer could step away from the property 7 or 8 yrs later & would have gotten all his money back, i.e. a return of at least 10% on his money & the property would revert to the original seller. If it was done as a land-sale contract, it could be renegotiated between buyer & seller without a tax penalty on the reduction of the balance due, and therefore there was no constructive receipt by either buyer or seller so it wasn't a taxable event.

The 2nd hurdle is the passive loss limitation (i.e. passive net losses can't offset income from the other 2 sources - portfolio & earned). There is a phase-out - by 1990 none of it is eligible beyond dollar-per-dollar in the passive bucket.

If your adjusted gross income is less than \$100K and your active rental loss is less than \$25K, don't cash in your bonds to pay off the mortgage on your property - it won't reduce your tax bill. But, instead, pay off your mortgage if your nonpassive income exceeds \$100K, your active rental losses exceed \$25K and any time you have a mortgage debt on passive rental property. What happens is that when you take the soft loss (depreciation, a non-outlay kind of expense), and you tack it onto the interest rate, your losses exceed

available income, & at that time you're burning up the depreciation until such time as you sell the property & can recoup the unused part of your shelter. What you have to do is then get less debt & have a lower "hard dollar" deduction on the interest rate, & therefore the shelter can slide in and cover real earnings & be used immediately. This suggests that leverage is not the game employed at this point.

Passive activity income is earned from rental activity & other passive activity, but doesn't include interest on escrow accounts.

Gains on sale of rental real estate are passive activity assets; interest earned on installment notes from the sale of such assets is passive activity income.

Hurdle #3: investment interest limitations. They weren't taken seriously before, but now are significant constraints.

The new law prohibits deductions for investment interest expense in excess of investment income. For this purpose, net passive losses which are deductible are deemed to be negative investment income. If you have \$100K of investment income but have a negative passive income of \$25K, you only have \$75K of passive income now & therefore can only use \$75K of interest as a deduction in that period. This is one of the few places where it "slops over", i.e. you can't carry the negative tax loss in the passive category to shelter income. But it does carry over to reduce the definition of how much interest is deductible, because what they don't want you doing is borrowing money on your life insurance & paying interest to your lender under the investment account, & then using that as a down payment to hike the depreciation in the passive account and carrying back that depreciation to shelter something else.

So this discourages you from collateralizing your real estate with your bond or stock portfolio. You can get too much passive loss that will reduce the deduction of the interest & thus discourage over-collateralization of the real estate with securities.

There's no \$10K allowance as there once was, i.e. interest paid to related passive activity is not investment interest. For example, if you make a loan to your own subchapter-S corp. & get the money out in the form of interest income (that the S-corp. is getting) it doesn't count - you can't borrow on your investment portfolio & by changing the character of the way you get money from the real estate to the investment account make it something it ain't.

Interest disallowed carries over indefinitely, i.e. speculating with land becomes an expensive game to play. Whereas in the old days if you bought investment land & it had a 10% interest rate on the land contract & you were in the 50% tax bracket, your real cost was 5%, as long as the land continued to appreciate at greater than the net cost of your interest (and the shelter factor was applied) then you did well.

Debts which generate investment interest expense are 2nd in line to consumer loans when it comes to retiring debt. Consumer loan interest rates are no longer deductible, but home mortgage loan interest is still deductible, as long as the loan doesn't exceed the basis of the house.

Hurdle #4: the alternative minimum tax (AMT), has become a much more meaningful factor. There is one AMT for individuals and 2 for corps.

All taxpayers must recompute tax liability under the AMT and pay the greater of the 2 taxes.

Take investor's gross income, add back the tax preferences (see handout), subtract certain allowed deductions, subtract your standard deduction under the minimum tax (\$30K for single taxpayers/\$40K for married filing jointly), which gives your alternative minimum taxable income, & then multiply that by the tax rate applicable to minimum taxes (not the regular 25% rate), which is a flat rate of 20%, and that gives you your AMT.

In 1987 capital gains will no longer a preference, so that that doesn't get built back in there, accelerated depreciation on all property is a preference. It used to be the accelerated depreciatiton taken on office bldgs was a preference but not that on apartment bldgs.

Installment gains on dealer property or rental real estate is a preference. That was never before a preferential item, e.g. if you sold your farm & got 5 annual payments from the buyer you were taxed at the progressive tax rate which applied to the lower level payment - the one that fit the principal minus the basis. Now that installment gain over the amortized basis against that gain is preferential income.

Passive losses, without phase-in credit are another preference.

Minimum tax credit: to the extent that the AMT exceeds the regular tax, a minimum tax credit is carried over to future yrs to offset regular tax. This provision adjsuts for timing differences which may cause AMT in 1 yr & regular tax in another yr. So if you have sporadic gain, you can level that out. It's really a back-sided income-leveling device - you can't average income anymore, but where you have a big year and owe the AMT rather than the regular tax, you begin to recover that payment against future regular tax, so it's kind of a back-sided income tax averaging.

Interaction with Wisconsin minimum tax: under the Wisconsin rules, Wisconsin's minimum tax is assessed at 55% of the excess of AMT over the regular tax, & Wisconsin will assess tax on the timing differences without future tax credit or other relief.

Finally, by 1988, when the regular tax rate falls to 28%, the impact will be much more noticeable.

(handout) Ex. #1: an MBA with \$70,000 in salary has \$25,000 from a land-sale contract, \$5,000 in interest & capital gains from real estate & other income of \$17,000 for total gross income of \$117,000. So far no differences with the previous ('86) tax law. The capital gains credit of \$10,000 is for the 60% that wasn't taxable under the old law. Rental & partnership losses are less in '87 (less depreciation allowed) and there's no married couple deduction anymore. Under the new law ('87) depreciation cut is a little lower & taxable income is higher (due to less allowed itemized deductions). In figuring the alternative minimum tax (AMT) all accelerated depreciation on real estate must be added to adjusted gross income (as a preference). In figuring itemized deductions, interest on home mortgages & land-sale contracts remain fully deductible. Deductible interest paid on investments is \$9,000 in '86 but only \$5,900 in '87 because investment income (as defined) has gone down (see hurdle #3). The consumer deductible interest, \$2,000 under old law & \$1,300 in '87, is being phased-out, so 65% is deductible in '87.

Miscellaneous deductions are also less in '87. Total itemized deductions were \$32,000 under old law & are \$26,500 under the new law. The personal exemption has gone up considerably. The taxable income in '86 was \$5,000, is \$23,400 in '87 under new rules & under AMT in '87 is \$31,500. Tax is \$500 in '86, \$3,400 in '87 or \$6,600 under the AMT - in '87 they have to pay the AMT.

Ex. #2: a similar case, where the taxpayer repositions himself for real estate by refinancing his home, paying off the consumer loan & the loan on the investment (with the home refinance money). His '86 tax is still \$500, and under the '87 tax law it's \$2,800 (lower), but the AMT has dropped from \$6,600 to \$4,300, so he is obviously better off to refinance the home, pay off the consumer loan and get rid of the payments on the investments.

Ex. #3: Here, having repositioned himself as in Ex. #2, what happens now if he cashes in his "other interest" assets, buys a passive income asset or pays some rental debt obligation? He is again with \$70,000 wages, his land sale contract gets him \$25,000, and he now cashes in his "other interest and dividend assets", having real estate gains of \$16,000 and "other" gains of \$1,000. His gross income is \$117K in '86 vs \$112K in '87 now, his capital gain & married couple deductions are lost under the new law, partnership losses have gone down for '87, and adjusted gross income is \$41K in '86 vs. \$55.4K in '87. His itemized deductions in '87 are almost what they were in '86 due to home mortgage refinancing; taxable income has dropped a little in '87, to \$2,500, & his AMT has dropped all the way down to \$3,100. When we get to Mr. Clifford, we may have to reconstruct Mr. Clifford the same way, in terms of positioning for real estate and then coming up with a balanced asset account, "passive bucket", so his shelter matches his income for real estate, a little tougher to do than it once was, but obviously a critical element in trying to avoid the AMT.

(question) "What happened to the married couple deduction?"

(answer) "There isn't one available anymore?"

OK, let's start to build on that. The basic elements of the tax strategy, 1st acquisition, has to do with what kinds of shelters I want. 2nd, recognition that once you buy a property you are likely to be in it for a relatively long period of time. There's no advantage in taking capital gains anymore, since it's the same as income. You do get the benefit of a multiplier if you move the income from \$10K to \$20K and double the value of the property. You can sell it & take your gain & pay the tax in 1 lump sum, but presumably you'd pay the same tax if you'd taken that income as \$20K per yr.

So looking at real estate, you want real estate that has: 1. durability, i.e. will sustain its value over a longer term & 2. can be enhanced, i.e. by care & some further investment to increase the value of the property, and transfer it to your heirs at a price significantly higher than what you paid for it, so that they 1. won't pay the capital gains tax & 2. can begin whatever depreciation there may be available at the point in time all over again from the new basis on which they may have paid inheritance taxes.

We need duration & the ability to improve the property (story about large gain on sale of realty).

Now, having decided we want a property with durability & fixability, the next thing we must decide in the acquisition process is 3. what mix we want between land and structure with a reasonable life of either 31 1/2 yrs for commercial or 27 1/2 yrs for residential property. How much do we want to put into personal property, having a useful life of 3, 5 or 10 yrs? The more we can allocate towards the personal property the more quickly we can provide shelter for taxable income we get from the property. Obviously some properties lend themselves more to that formula than others, e.g. a run-down apt. bldg. which we can refurbish & refurnish & provide new appliances for will be a more attractive blend of opportunities, than, e.g., a commercial shell bldg. in which there is no personal property & which doesn't lend itself to any enhancement & isn't as well located as the older bldg.

The acquisition process has to anticipate how we are going to present the bldg in terms of several different issues: 1. what class of structure do we want to talk about? There are 5 classes: a. single-family residential, b. farm & extraction properties, c. residential, d. commercial & e. subsidized. For example, if we buy a single-family home, we will want to make it our legal residence so as we pass 55 we can take all the gain as an exception to gains tax & then we will want to rent it. If we are 47 yrs old & rent our house & establish a new residency, then we just blew all our shelter in that house.

Or, for example, say we buy a farm or extraction property. For a while "hobby farms" were popular, where you raised a couple o fhorses & ran up the net losses to deduct against income. You can't do that anymore. Rather, you have to make money 3 out of 5 yrs. If we lease the farm we have rents (passive income), but if we have a joint venture with a farmer (i.e. each ows 50% of the cattle, equipment, etc.), then it's operational income. As a joint venture it's more liability, but 1. it can be owned as a subchapter-S corp. to limit liability and 2. it's not rental income so it doesn't run afoul of the restraint on rental income for subchapter-S corp. formats.

So the 1st thing to know is what category it's in. Is it a farm? How do I prove it? (story about orchard Chief bought)

How much gravel do I have to take off the property before I have an extraction property? Do I really want to be in that category bad enough to prove it? I better lay down my audit trail so that everything is supportive of that. (story about farm he bought with Robbins)

"Residential" isn't too hard, but you have to have at least 80% of the property in residential use, according to the FHA rule, you weren't entitled to FHA insurance unless 80% of the income & 90% of the space was in residential use, rather than commerical. Of you fell below that you had to split the bldg to remain in that category.

Finally, we're down to subsidized properties. There are a variety of subsidies: 1. Section 8's, which are direct rental subsidies, 2. those properties financed with below-market loans, by SBA, FHA, etc. The gov't is strict on "double dipping", so if you have one of those loans the investment tax credit is reduced from 9% to 4% on e.g. new residential property for low income qualified tenants.

So, #1, you have to know what category you're in. The 2nd thing you have to know in your acquisition process is: for what purpose am I acquiring the property? There are 3 categories here: 1. for use in a business - has slightly more generous write-off terms & you're entitled to take the ordinary losses on sale of that property against other income (this is true even if it's a proprietorship). 2. for investment and appreciation, or 3. dealer status (i.e. the property is on the inventory, available for sale like any other trade goods).

The real estate can be any 1 of all 3 of these categories, or the property can be 2 of these, e.g. you can buy the bldg to house your operations as a real estate broker & developer (for business use) and split the property in 2 and have the office for business use & the balance as an investment for income & appreciation (to qualify for captial gains under the old law). If you bought it as a dealer you could never get capital gains tax, e.g. a subdivider of lots is a dealer & it used to be taht he wasn't entitled to capital gains, with 2 exceptions: 1. if the business acquired the land for another business

purpose that became obsolete or unnecessary, they could dispose of the land & take a capital gain, & 2. where you inherit the land & then subdivide it to dispose of it - your basis is the value when you get it & any gain is capital gain.

It is suggested that one way to move real estate income out of the passive category into the earnings category is to be a dealer. It used to be you didn't want to be a dealer but now it can be good.

In addition to these categories, the next thing we need to know in the acquisition strategy is (#3) when to anticipate when we plan to acquire, when we plan to dispose & where we want the profits to fall. We need to structure our acquisition to accomplish whatever purposes those may be, e.g. if I want the income only on retirement I might decide to acquire the real estate through my pension fund in my corporate shell. The income would go to amortize the mortgage but none of it would be available to me now, but when I brought it out of the pension fund it would be subject to a tax. If I wanted to give it to my kids & this was a wealth transfer device I might use a tax-freeze holding device such as a family corp. with 2 classes of stock, preferred & common. I then give my kids the common & the preferred is exactly equal to the purchase price. Gradually I call the preferred & any appreciation on the property all goes to the benefit of the common, & when I die the only thing in my estate is the common stock, automatically valued at the call price, & all the wealth increment would have been transferred to my children without benefit of the gift tax or inheritance tax and no charge in terms of administration of my estate.

If on the other hand the play is to give me leverage so I can trade up, what do I want to trade? Maybe I want to trade stock for stock? Maybe I have to acquire it through a corp. so the basis is in the corp. If I acquire it in my own name & then put it in a corp. later, the only basis the corp. gets is the basis I had when I bought it.

So I need to know when to acquire it, when do I dispose of it & where do I want the net profit to land. Corps. do this all the time, i.e. deciding how to show it for their own particular corporate purposes of earnings per share in a certain quarter, getting it out of the corp. & hiding it as a submerged asset, in some cases they want it to appear as a big bonanza, & sometimes they don't want it to appear at all. The less people know about a corp's net real worth the less likely they are to raid. Corps. are sensitive to that - if people figure there's a lot of real estate they'll have a leveraged buyout; they may want to "spin off" some of the "crown jewels" & bury them here & there so it's not so obvious what the real estate position is.

Given these considerations, the acquisition of a piece of real estate gets to be a sophisticated play, even for something as basic as a 4 unit or an 8 unit or a small commercial property with a triple-net lease on it.

A further element in the acquisition formula is to refine the kinds of assets acquired. What class do I want them to fall under in the IRS code, e.g. 3-5-10 yr. category? What evidence can I have to allocate the purchase price to those categories of personal property that will withstand IRS scrutiny? Do you need a bill of sale for equipment & furnishings? Do I need a statement as to what the land was purchased for as vacant? To what degree is the assessment ratio of land vs bldg applicable? The IRS isn't necessarily bound by it. One comfort you have as a small investor is that it may not be worth the effort by the IRS to pursue you, so you want to push it as far as you can. It's the holler theory of tax allocation, i.e. you allocate it the most favorable way until the IRS hollers & then you holler back, and then you decide if they're going to make an issue out of it & whether it's worth it. You arrive at some small compromise which allows them to indicate that they collected some additional tax on you.

Real estate 850
Feb. 10, 1988 Lecture
Outline by Evan Harrison

Beginning of class: Prudential has 2-3 openings in Atlanta. They just placed Frank Lohas from Chicago to Atlanta, so you will have to get the phone # out of Atlanta information. We also posted some full time jobs on the job board.

Mark Eppli has just completed a tax theory course in the law school and has paid taxes himself several times. He has agreed to take the pressure off my lungs, and pick up on investment tax credits.

Case study questions: Contract rents are the rents stated on the contract. If it says \$12/ft/yr, that would be your contract rent. Effective rent is contract rent less free rent, so if you have say, 2 mos/yr free rent, you would have an effective rent of \$10.

A squeeze down is a joint venture agreement in which both parties agree to provide a certain amount of equity capital initially, then if the project doesn't run according to expectations, one party puts in the additional needed funds, and the other party goes from a 50% position to a 25% position, and if still more funds are needed because, say the project isn't marketing very well, then he's out altogether, with a 0 position in the joint venture, or sometimes gets reduced to a slow-pay subordinated note. As we'll talk about later, courts will generally not support a total wipeout of your equity position, feeling it too harsh a remedy for failing to meet the call for additional capital, but will allow you to change your position from a joint venture partner to a limited partner or change your position to a slow-pay note with interest at 5% which accumulates toward a payment 10 years down the road, so you can't say they cheated you out of it, but it will be a long time before you see it.

Free rent is now generally given as two months at the beginning of each year to avoid tenants who get six months then leave and claim you somehow did something to breach the contract.

Assume today's depreciation rates. Even if you'd cut the deal in '86, you would not be entitled to dep. until '87, and would be under the new law anyway.

Eppli:

DEDUCTIONS AND CREDITS:

Deductions as in depreciation are subtracted from the gross income to reduce taxable income, and is worth 28% if you are in that bracket. A credit, is in rehab tax credit, is a dollar for dollar reduction in tax liability. A \$ credit is a \$ tax savings.

DEPRECIATION: For commercial and industrial property it is 31.5 years, for residential 27.5 years. Personal property is mainly 7

year property, but could be 3, 5, 15, or 20. There are other non-statutory ways to take depreciation. For example, the Hertz Corp., takes > actual dep. on vehicles than allowed per statutes, so they used what they've proven over the years, so they use something greater than that. In R.E. that comes in with tenant improvements and leasing commissions. That would be improvements specifically for the rental of the space, and wouldn't improve the life of the building or be a capital improvement, and can be depreciated over the life of the lease.

Chief: When McDonalds changed their marketing strategy to include seating in house, they were able to show that the rate of obsolescence in fast food was perhaps 7-8 years, so they can use an 8 year life. If you keep historical records, and can demonstrate that the historical life is less than allowed by the code, you can establish your own useful life.

The next thing on the outline is section 179 - RAPID EXPENSING. That was expanded per the '86 tax law, and is used mainly by small business. You are able to take sec. 38 property -tangible personal property used in a trade or business - and expense up to 10,000. If you bought a computer and printer for 12,000, you can expense 10,000 of it. If you bought more than \$200,000 of such property, you start to lose this benefit, so it is mainly for the benefit of smaller businesses. If it is . \$10,000 you might buy in Dec. and make 2 payments out of it and get 2 credits.

CREDITS: The ITC was repealed retroactive to 12-31-'85. Don't be surprised by retroactive changes. It pays to stay tuned with proposed changes. The ITC has mainly been used to stimulate the economy. The Rehab credit. The old law gave a 25% credit if you were on the Nat'l Register of Historic Places, and you only had to reduce your basis by half that amount. There was then a 20% credit for buildings over 40 years and a 15% credit for buildings over 30 years. In the new law, you get 20% for structures on the national register, and a 10% credit for buildings built before 1936. So you have a building that is 52 years old. Your total rehab costs have to be greater than the adjusted basis of the purchase price, which means that if you are negotiating a building for rehab purposes, you want to negotiate the lowest price possible, and if necessary compensate the seller through other means so you are not forced into a rehab budget which exceeds what the property needs or can carry. There is now a 100% REDUCTION IN BASIS FOR EVERY \$ TAKEN IN REHAB CREDITS.

PASSIVE LOSSES: The three types of income are COMPENSATION, which is wages, salaries, and tips, and PORTFOLIO INCOME, which is stocks, bonds, and securities, and PASSIVE INCOME, which is limited partnerships. You cannot offset passive losses with other types of income such as compensation income. The only person this doesn't apply to is those who materially participate in the deal. You almost have to be a dealer in real estate to be a material participant or a general partner. In many instances, a G.P. is not deemed to be a material participant. In order to keep the classification of active income you have to participate in the management, and then you lose

the protection of a L.P. and are classified as a G.P. Chief: limited partners are permitted only three areas of discretion: sell, refinance, or get rid of an incompetent G.P. They've had cases where one of the L.P.'s commissioned someone to plow the drives after a snowstorm and signed a receipt for the snowplow and lost his status. That blew his cover. Passive income is virtually any kind of rental income, whether you are a limited partner or not. The form of ownership isn't the critical thing, it's the source.

Ans. to ?'S: You can be both a G.P. and an L.P. up to 20%. If you are managing you own property in your own name, that's still passive income. Brief discussion of \$25,000 exemption "for the little guy" where husband and wife both work and have a couple of duplexes. Today that's covering the blue collar family. It phases out 50 cents on the \$ between \$100,000 and \$150,000. You also have must own at least 25% of the deal and be an active participant in the deal.

Examples on chalkboard. One taxpayer in two partnerships, one with \$20,000 gain and one with \$50,000 loss. Net loss is \$30,000 annually.

	Year 1	Year 2
Taxable income	\$100,000	\$120,000
Maximum passive loss		
write off	(\$25,000)	(\$15,000)
TAXABLE INCOME	\$75,000	\$105,000
Carryover	\$5,000	\$15,000
Accumulated carryforward	\$5,000	\$20,000

On sale:

	Example 1	Example 2
Selling price	\$180,000	\$120,000
Adjusted basis	\$100,000	\$100,000
Gain	\$80,000	\$20,000
Less Accum. carryforward	(\$60,000)	(\$60,000)
TAXABLE GAIN	\$20,000	(\$40,000)

The \$40,000 of net passive loss at time of sale in example 2 can be applied at that time to offset other types of income. Upon sale, the \$25,000 limit does not apply.

Chief: Notice that in the acquisition process, one of the things you have to think about is "What do I want to acquire, the tax entity or the real estate?" If this was a RE entity that was set up in 1985 and enjoyed the tax law that was in place at that time, you might want to buy the the stock or the whole partnership and continue forward on the accounting entity that was in place at that time, and continue forward under the old rules. By the same token, let's assume the RE has a substantial suspended carry-forward. You might want to buy the corporate or business entity in order to have that carry-forward available some time in the future. The seller might have reasons to do that too, or he might want to trade stock for this

corporate entity and go forward in that manner. It becomes valuable to sell the suspended entity. Do I want to buy the entity, or the RE itself?

Eppli: You can take credits for passive loss purposes also, where one \$1000 credit is worth $\$1000/0.28 = \$3,570$. The passive loss deductions are always used up first, then the credits second. Chief: The passive loss deduction does not apply to corporations at all. You're talking only about individually owned properties and single conduit tax entities. I was talking about tax investment credits and unused depreciation under pre 1986 rules above when I said you sometimes want to buy the corporate entity instead of the RE.

Eppli (Ans. ?) If you have \$20,000 in passive losses and \$10,000 in credits, you can only write off the \$25,000 limit, and you have $(\$10,000/.28 - \$5000) * .28$ of credits to carry forward.

Chief: It works out that anything you earn over \$100,400 is taxed at 28%. You are charged a higher tax rate which is offset by the partial deduction of passive losses.

Eppli: If you earn 0 - \$17,850, your tax is 15%. If you earn between \$17,850 and \$43,000 you pay \$2677 plus 28% on anything over \$17,850. \$43,150 to \$100,480 there is actually a 33% rate. What is being done here is to recapture the 13% you saved on the first \$17,850. In addition, you have a personal exemption of \$1900. So it works out that every dollar you earn when you make over \$100,480 is taxed at 28% and your marginal rate is equal to your average rate.

NO COMPETE CLAUSE: If a developer is selling a shopping center for \$2,000,000, the buyer has to depreciate it over 31.5 years. But if I buy the center for \$1,700,000 and pay \$300,000 for a three year non-compete clause, you can depreciate the \$300,000 over the three years. Both sides of the transaction have to match. The developer can't take that \$300,000 as capital gain. It is ordinary income.

Chief: You can also have a consulting fee to help him take over the management and leasing commissions on the remaining income from leases already in place, and in fact being purchased and assigned with the property acquisition. All of that allows you to accelerate depreciation on that portion of the investment, and the total dollars paid still adds up to what you were going to pay for the shopping center. There is a great deal of creative accounting as to whether I bought a tangible asset or an intangible asset in the form of leasing services and non-compete clause and consulting services and whatever. The more inventive you could get, the lower the real estate price appeared to be. From the seller's standpoint, he might be able to shelter the ordinary income another way and give the buyer his write off so the limited partners coming into the partnership over three years were getting enough write off to simply pay for the investment with their tax savings on other income. Now uncle has tended to spike those as rapidly as he can.

Eppli. 3 TYPES OF SYNDICATION COSTS. The first type is to organize the partnerships. You can amortize those costs off over 60 months or more. The second is the costs incurred to acquire the RE which is added to the basis in the real estate.

Chief: Costs which are for loan purposes are written off over the life of the loan and the others over the life of the real estate. So the appraisal would be written off over the ten year, say, loan life, while the engineering fees would be over the life of the property.

Eppli: the third category is the costs of marketing the limited partnership. Those you can't write off at all. You simply add them to the sales price, but there's no deduction as you go along.

The last category I have here is Master Limited Partnerships. For all practical purposes at this point they are dead in the water. Originally, master limited partnerships were set up to be passive income generators to offset passive losses on limited partnerships which many people bought, but in Dec., '87, regulations, MLP income was considered to be portfolio income, since they are traded on stock exchanges. Starting in 1988, they will be deemed a corporation. As corps., they will be double taxed entities, which doesn't work too well for real estate.

Graaskamp:.. If the tax status isn't quite clear (as with Master Limited Partnerships) and a klutz doesn't read the prospectus, that's his problem. Eppli (answering a question): Let's say you have limited partnership shares at \$50,000 apiece and Merrill Lynch or whoever is selling them will sell them at a commission rate of 6 to 9 per cent. Say 6. It will cost \$3,000 to sell this particular limited partnership share. this \$3000 is not deductible as an expense, and you cannot amortize it. The only time it comes into play is when the partnership is finally liquidated, it can be subtracted from the sales price it determining gain. Graaskamp: It's part of your basis going in.

Graaskamp: In looking at the acquisition of any property there are two tax considerations to keep in mind: how to structure for the seller and how to set it up for the buyer. Which works out best for both? As we argued often in 856, the price is ultimately engineered to lessen the impact on the seller and maximize the benefits for the buyer.

For example. The seller may have some interesting problems. Let's say you're buying a one-day medical-surgical center type facility, where the state of Wisconsin until very recently would only allow one of those per community. That's a franchise, and not a strictly real estate enterprise. Franchises are never entitled to a capital gain. they're always taxed on sale as ordinary income. It's pretty important to load the price of that particular kind of business into the real estate, so the seller can take his profit as capital gain and pay as little as possible on the sale of the business, which is always ordinary income. On the other hand, if you

were buying an industrial plant with inventory, machinery, etc., it would be advantageous to load as much as possible of the purchase price into the inventory and purchase of existing contracts and retainers that were in place for that kind of firm, so in effect you could write off as much as possible of the purchase price against sales as a reduction of inventory as opposed to depreciating the real estate over 31.5 years. Obviously you can't be absurd, but there are a lot of judgment calls, a lot of room for erring on one side or the other depending on the deal and then daring the IRS to find it and then fight about it. The parties need to find out what their purposes are.

For example, the deal of the year for the SIR a couple of years ago was when Gordie Rice bought the old Gisshold-Johnson plant. Johnson had been absorbed by Giddings and Lewis who had moved all of their operation except for the foundry - up to Oshkosh or wherever their headquarters was. Now they've got a plant on their books which had a book value higher than the market value. Giddings and Lewis didn't want to take a one-time write down because the securities analysts would be on top of that immediately, so they said "You buy it from us for our book value, or to give you a small profit, and we'll lease it back from you. So the losses on the empty building were being feathered out against years in which they had taxable income, and they were converting a capital loss into an ordinary loss in the form of rental expense. They had a release clause that said when Gordie began collecting rents, they would be released from their obligation, so it gave Gordie a positive cash flow on a vacant building the day he took it over, and he could offer prospective tenants several months free rent because he didn't have to take a credit against the rent he was getting paid by Giddings and Lewis until the tenants started to pay hard dollars. It isn't hard to make a deal work on that kind of basis. Giddings and Lewis got what they wanted, too. They were allowed to extricate themselves from a surplus industrial facility where Gordie Rice took over the operating costs, they did not have to take a hit on the surplus and alarm the securities analysts, they were allowed to write off the loss as an ordinary loss against future income, and for that matter, they were allowed to use the foundry for another nine or ten years. So both sides were looking at the tax consequences and structuring the deal in such a way as to optimize on either side of the equation. With the cash flow from the project, Gordie was able to borrow enough money to make tenant improvements and turn the facility into a multi-tenant operation.

Most deals are structured in that way. What does the seller need? What does the buyer need? How does FASB accounting treat that?

Dick Sheidler will be here later this Spring. That's really his whole game - understanding the corporate culture and FASB accounting rules sufficiently to understand when there is a buy point when he can buy the property at a price lower than market price, while making it appear that the seller took a profit. So let's say you have an industrial building that was bought on a sale-lease back with a 25-30

year term. A lot of these deals were acquired around '67-'72. The accounting rules at that time required that you take the present value of the rent payments, and treat them as though they were an amortized level-payment mortgage and put that on the liability side of your ledger. Prior to that time, you didn't have to recognize more than one year's rent. At the same time to offset that, you put on the asset side the true value of the facility. Since you were allowed to depreciate the asset as though you had bought it, you ran the asset side of your ledger down very quickly, but the liability side was being run down just like an amortized mortgage with the large principal payments not occurring until later. So in effect you were understating your surplus, because your liabilities were out of kilter with respect to your assets. Furthermore, you had to do that, if you had a lease longer than three years. So if you had a corporation which had a little downturn in its earnings for a particular year, he could go in and say "hey, I'll tell you what I'm gonna do," I'll buy that leasehold position from you for x dollars, and lease it back to you for 23 months or 36 months or whatever, and give you the option to renew that to what would have been the end of your thirty year term. Since that takes the asset off the asset side and the liability off the liability side, and the liability is significantly larger than the asset, it drops right into surplus as earnings. Now Sheidler is sitting in the position of a sandwich lease, and he is making the payments to whoever made the sale-leaseback in the first place. The tenant in the property in the first place is now making rent payments to Mr. Sheidler. Those rent payments, in a deal cut in '68 - '70 are significantly below the market rent for the space today. the only risk is if the tenant doesn't renew, but all he has to worry about is releasing the property for something more than it was rented for in the early days, and then he is home free and his cash flow is more than it was before. Now he turns around and looks at the guy who owns the building and there's fifteen years to run on the lease at 7.5%, which was not a bad deal in '68, and he says, gee, the leasehold value in this building is substantial, let's say it's a 5 million dollar warehouse, and currently given the present value of the rent stream to you to the end of the term, even assuming a resale price which is fairly favorable, is 3.5 million, and I've got a leasehold value of 1.5 million, so I'll pay you 4 million for the property. You can reinvest the four million at current rates, and I'm buying the building by reassembling the fee at a million dollars less than market. In most cases the seller would go through with that. He hasn't been able to extricate himself, because the hit would have been too great, but chances are, he has already depreciated the property below the 4 million mark, so he's going to register a profit, too. So the fee holder comes out with a capital gain less than he would have liked, but at least he has his money back to reinvest at current rates which are more opportune. The tenant's out from under, he's just taken a little hit in the surplus to improve his earnings, he's happy, and what's more, he's improved his corporate flexibility, because he now has a series of three year leases, so any time he wants to pick up and move he can do that. Mr. Sheidler in the meantime bought the leasehold at less than its value and the fee at less than its value, and he's assembled an asset

he can flip for a substantial piece of change. Given the credit, let's say, a national credit of the tenant, and given that he bought the asset at less than market, he can in fact finance out on the whole deal, and never have a nickel of his own money in it. Notice that he is playing the FASB rules on the one side, and the fact that the asset manager on the other side looks bad because he's got an asset that is generating a rather miserable cash on cash yield, and investors, say in pension funds, want more cash on cash, and if they realize there's no upside left in the property for them, they're happy to get their cash out and reinvest it at the current yield. Even though he's given away possible capital gains ten or fifteen years from now, everybody wins - a totally engineered deal. Now some poor appraiser will go down and say "this sold for 4 million, so that's the market value." Baloney.

So you have to look at the acquisition. How do I want to set it up for tax purposes? How do I want to set it up on the seller's books? And notice if the seller doesn't work consistently with you, as Mark pointed out, uncle Sam smells a rat, they'll go back and unwrap the transaction on both sides and say "here you treated it as a capital gain and you treated it as a fee, what goes on here. Obviously it must have been a capital gain, so you can't write it off over three years, you're going to have to write it off over 27.5 years." You really have to make sure that doesn't occur.

One of the classic leaseback cases involved 3M leasing a warehouse in Minneapolis, and the developer came in and wanted 100% financing from the bank, which said we'll make that a triple net lease with 3M, and you assign us 100% of the income until the financing on the warehouse has been amortized. If you want to step in and buy down the mortgage, we'll restructure the deal and you can save some of the cash flow. Now, the nominal owner of the building depreciated the whole thing and took his payments from 3M as rental income and and deducted all of his payments to the lender as interest. The IRS said the lender who has title to the property as security for his loan didn't have any operating risk at all - it's a 3-net deal, the guy in the middle made all his profit up front in the construction fee, etc., and the lender says in effect that while he has title, you can have the property back any time you want to give him x dollars and make it an 80% loan again. Your deal with the lender really isn't rent to the lender at all. IT DOESN'T MATCH UP. The lender has no ownership risk. Therefore, the lender isn't the owner, therefore the payments to the lender aren't rent. And indeed, the lender's books showed it as a mortgage loan. It didn't matter that they were holding the deed, as far as they were concerned it was a straight mortgage deal, interest and principal. The developer had been deducting all of his payments to the lender as rent. that didn't match up with their documentation as far as their in-house accounting was concerned. The deal was off, and the (sic) lender had to go back and pay taxes on the principal payments he had been making to amortize the loan.

So you have to be confident in an acquisition that the seller is going to treat all the various dollars received the same way you are

acknowledging them for your tax purposes as outlays, and that is part of the negotiation leading to the final closing- how each party will handle this element.

The second thing you are going to be concerned with is **timing**. One element of timing which has changed slightly is that depreciation works on a half year rule and a quarter year rule. If you buy real estate in the seventh month, you are allowed to depreciate only six months of that year. If you buy in the first month of the year, you are allowed twelve months of depreciation on it. You buy it in the last three months of the year, you are allowed only 25% of a year. That's a change, because in the old days, you could buy it in December and depreciate it for the full fiscal year. So they chopped down on that. So now if you need a little extra kick early on, you may want to close part of the deal on Dec. 28 at the end of one calendar and fiscal year, and close the other part of the deal in the next fiscal year. So if you are limited to 25,000 of tax losses, you can get that to fall in 2 different tax years, and you can time your closing accordingly. By the same token, if you need to take the expenditures for certain elective items, you make sure you get them to fall in the tax year which has income. One of the advantages of the so-called convertible loan, is that if a pension fund comes along and funds that loan, while technically they may be willing to come in as a joint venture partner, and put up 90% of the money and own it, their depreciation is going to get burned right up the chimney because they are not taxable. So by making it a convertible loan, the interest payments made to the lender, which may be all the net income in the property, are totally deductible for the developer, and the depreciation and other tax credits as they may be, may all go to the developer or his other equity partner. Then 7-8 years later, the lender has the right to call on the property and take a 75% ownership position and forgive the debt or I want my money back. It didn't turn out as well as you guys said, you're going to have to refinance it, and so forth. But notice that they've structured it by this deferred ownership position, so that the tax benefits are going in one direction and the other benefits are going in another direction.

Another way to do that is to split the land and the building. One party which doesn't need shelter owns the land and takes land rent plus a participation. The other party owns the building, and is able to take depreciation relative to his entity. There is very little income during the depreciable phase of the project. There are different ways to carve up the interest to provide ONE, allocation of the tax and income and capital gain benefits, and TWO, modify the timing as to when each party receives it.

For example, if foreign capital is structured right, there may be no capital gain tax at all if you dissolve the total entity. Sell off the total thing and take your money home. As a result, they may structure their deal largely as debt, with a kicker of participation in the resale. They in effect simply liquidate the whole enterprise and take their profit home in the form of a one lump liquidation dividend.

In the old days it was also possible for the American entity to have a single 30-day liquidation and pay no double tax coming out of the corporate structure, but that is no longer possible.

So again, the timing and character of the distribution is something you want to build in up front.

That's it for today, we'll see you on Monday.

Mr Clifford Case

-use the MRCAP program, it was designed to do that originally; put all of the land in 1 account, the land for each of his identified properties, seperately in terms of its basis; & then you can have 1 line for each of his investments & you'll have to work out what the basis is going in, & in several cases there will be no basis, he will have utilized all his depreciation; & then the valuaition method is suggested in the case so each year you know what the going value of his real estate is, simply use a NIM so you will produce a resale price; the resale price against the lower basis will have some substantial capital gains characteristics to it which are part of your problem; do you sell now or wait for Mr. Clifford to die & what will it cost him to die? the stock & bond fund can then be put in the initial reserve account of MRCAP which is also permitted to earn interest; if you'll recall, interest rate earned net after taxes is reported in the case so that you can in effect run his other investments along on that basis; so you can come up with an at least crude estimate of how his estate will accumulate from 1988 forward, what his tax bite would be if he sold & what his gross estate would be if things accumulate as they have.

-you'll have to make some of your own assumptions as to what you think will happen to his real estate portfolio; you can pretty much take the assumpitons made for the stock & bond portfolio; & you may havea to run individual analyses of 1 or more of the properties as you decide how you would advise him in terms of organization, disposition, planning for the day when he's no longer there; there's lots of loose ends flapping in the breeze in this case; therefore you are expected to find the loose ends & tie them down; don't come running to me "do we have to do this w/such & such?" - the answer is if you think it's important you better do something about it; anyway I think you'll find it an interesting problem; the problem is slightly different than it has been in the past because the progressive income tax rate isn't as serious as it once was; on the other hand the capital gains rate is no blessing; so this year we'll come w/different answers than we did in the past; if you have notes from the past, roll them out, since most of the variables that were true then ain't true no more - so have at it; have this in the Wed. after Spring break ...

Marital Deduction/\$600,000 Exemption

-OK, so lets talk a little more about estate planning, since that seems to be the topic of the moment; 1st of all a little bit abaout recent changes in the tax law which have changed the traditional formulas for estate planning; for a long time the basic marital deduction trust was \$250,000 or 50% of the estate, whichever was more, & in effect postponed payment of any estate or inheritance tax on that portion which fell in the marital deduction trust; the kicker on the marital deduction trust, however, was that the wife had to have general powers of appointment, that it was really her funds to do with as she wished, to give it to a new boyfriend ... or whatever else she was welcome to do that; & that if hubby was the 1st to go he was relinquishing control of 50% of the assets; now that's out of sync w/current marital law & the equivalent rights of the lady of the household & so the estate tax law now permits all the money to go to the spouse on a marital deduction basis, so you can postpone for a time the heavy hit of estate taxes; you may or may not wish to do so, but you can for a time, & the progressive rate would then hit the total estate some time in the future; because of the fact that the spouse may want all the benefits to go to the surviving spouse, but may not want to relinquish total control after that, they developed the QTIP trust, the qualified termination trust, so tht the surviving spouse can have the benefit of the income & partial principal liquidations if necessary then the testator can direct that the corpus be distributed on to his children, whatever, some other

beneficiary, & he doesn't have to give up general power of control to the survivor; so you have several types of trusts: 1. you have the classic marital deduction trust which gives general powers of appointment to the widow or widower, & 2. you then have a limited powers of appointment trust which is essentially a life estate to the beneficiary and then the funds are distributed under whatever conditions the testator may wish; the old format used to be 50% went into a marital deduction trust to eliminate any estate taxes on that portion immediately, the other 50% went into a limited powers trust in which the income went to the surviving spouse for as long as they needed it, & in addition the corpus remaining would then be distributed however they wanted to do w/it, e.g. children prorata, grandchildren, etc.; further more to maximize the marital deduction trust the taxes that were due & payable, the administrative costs, the expenses of last illness, etc., were typically paid out of the 2nd trust; so the marital deduction trust represented a gross 50% of the available estate & the 2nd limited powers trust represented a residual after everything else was paid for, so the amounts of the 2 trusts were not equal; 3. now w/the newer format you can postpone all of the costs of administration, etc., etc., & it will fall on the survivors under the QTIP survivors & partially on those who benefit from the general powers of appointment trust to the will; there's much more flexibility in how you structure that than there once was.

-in addition the tax rate has been reduced, the amount is \$600,000 before you pay any estate tax ...; the estate planning process depends more on protecting the asset from waste during administrations & protecting the asset from waste during administration & protecting the asset from prolonged litigation which will drain the estate through legal costs or poor management, & it's not unusual for an estate to be tied up for 20 yrs as they fight about it ... (story about the Wells Estate).

Gross Estate

-now, what constitutes the gross estate? (Question: How can you avoid problems like that? Answer: Keep it nice & clean, don't have too complex an estate, keep it simple & straightforward (story about a shopping center) ... anyway, building the gross estate:

-1. 1st is property owned at death.

-2. 2nd is property passing to spouse by elective share - most wills will say surviving spouse & children can choose \$15,000 personal property from the estate as a little memento ... & most wills provide to various children, relative, etc. come in & choose some memento of that sort - the value of those elements are included in the value of the gross estate ...

-3. next one: certain transfers w/in 3 yrs of death; part of that is due to the fact that the gift taxes might be slightly less than the estate tax, part of that is the gifts were given sequentially so they were below the taxable amount in any event; there is a rule that if the individual had reason to believe he was going to die & he was doing it for tax avoidance purposes they can include that in the gross estate, e.g. if dad has 12 kids & gives them \$10,000/yr, there's \$360,000 he's gotten out of the taxable estate, the IRS is likely to challenge that, i.e. say dad knew he had a terminal disease ... it isn't often employed & it's been slightly softened in the current law ... the rule used to be that the presumption was any gift w/in 3 yrs of death was in contemplation of death - now they've reversed it & the burden of proof is on the IRS.

-4. tax transfers w/a retained life estate or w/retained control; so if you give the farm to the kids but give mom the right to stay in the house for life, that's still w/in the estate.

-5. reversionary transfers requiring survivorship.

-6. revocable transfers - let's say you were the beneficiary of a limited powers trust but you died before anybody could renig on the fact that it had been given to you - at that point it's locked in & it moves forward - if you're the beneficiary of the trust & you have certain powers that could determine what to do w/the trust after you die, then that's part of your

estate - you might not have done anything w/it, but you had the option & therefore it was under your control & it's your property.

-7. annuities & employee benefits - close out sum on pension, PV settlement on your remaining pension program & so forth.

-8. ~~property passing by right of survivorship~~ - in other words even though you & your wife own the house jointly & you die, 1st of all your 50% of the house is in your estate even though technically title automatically passed to the survivor on your death, & what's worse is if the wife can't prove that she paid for her half then 100% of the value of the property is in the estate of the deceased; so it's really important that when you buy a house that husband & wife each write out a check for 50% of the down payment, that you each write out the checks for the monthly payments & establish an audit trail; there are certain limitations on that, you can get around some of that arguing the annual amount is less tahn the gift that would have to be unreported - but as soon as you get an amount of money which would have to be a reportable gift you either have to report it as a gift & pay a gift tax on the transfer to the wife or she doesn't technically have 50% ownership of her half; (Question) is a joint checking acc't adequate for establishing that? (Answer) only if she can prove she put 50% in it in the 1st place, i.e. establish her paycheck as well as yours went in it - that's one of the joys of communal property, establishing that in fact both contributed to it; (Question) so if the wife stays home & tends the children ou need to pay her a salary? (Answer) that's about what it amounts to, or make her technically a gift every month of the house payment; yes (Inaudible Question) ... the question is how much is in the estate of the deceased, 50% of the house or 100% (regarding contributions by the surviving spouse); yes ... \$600,000 is the minimum estate before the fed. gov't has an estate tax; the marital deduction could be 100% of the estate, all you've done is postpone the impact of the tax law until the spouse dies; distinguish the 2 things - if you have an adjusted gross estate of less than \$600,000 you don't have a fed. estate tax; (Inaudible Question) ... 1 type of marital deduction trust is a QTIP trust - in a QTIP trust the testator can maintain control voer where the principal goes on the death of the beneficiary; in a straight marital deduction trust the wife has power of appointment & she can change the will if she wants & have the money go to whoever she wants; (Inaudible Question) ... well what it means is that her marital trust will not have to pay any estate tax in the future as long as they pay out all the income, & since they've postposed the tax & they only put \$600,000 in the 1st place, assuming everything is paid out, then there's no fed. estate tax the 2nd time around when the widow dies.

-9. ~~general powers of appointment property~~ - if your dad left you a trust & you have general powers of appointment then the control factor is such that it was your property, you could have done whatever you wanted w/it, even if you only took the income from the other turst, the fact that you had the right to decide who was going to get the benefits when you die includes it in your estate.

-10. ~~Life insurance proceeds~~ are subject to the estate tax if they're payable to the estate; here's of course the great temptation to make the life insurance payable to some other individual, but again you have the power of control problem - there are 3 incidents of ownership of a life insurance policy & you must have given up all of them or the proceeds will be in your estate even though it was payable to another individual: 1. the right to decide who the beneficiary will be - you must give that up irrevocably; 2. the right to take advantage of the loan powers in the policy; 3. the right to take advantage of the prepayment powers of the policy - any life insurance policy has a set of standard agreements & for example if you got tired of paying for the life insurance you could step it back to a prepaid basis, you could require that the dividends were used to buy additions, or for that matter you could require that the policy be terminated & any cash values be returned to you; all of those elements represent incidents of ownership - unless you've given up all of those to the life insurance you own the policy technically, it's like having powers of appointment & therefore the proceeds are included in the estate even though they were paid to somebody else - which

is very dangerous if you have a big life insurance policy of \$1M & not much else & it all goes to somebody else, you may have a taxable estate even though you don't have any resources w/which to pay the tax; yes (Inaudible Question) ... then the life insurance proceeds are not included in measuring the gross estate; (Inaudible Question) ... but if at the instant before you die if you have any of the incidents of ownership & control of the life insurance policy it will be included in your estate constructively even though the proceeds have been paid to somebody else; (Question) how do you get around it? (Answer) what you have to do is file a form w/the life insurance company indicating that all the incidents of ownership have been transferred to the beneficiary; you may continue to pay the premium & that's your privilege; (Question) you have the right to change the beneficiary? (Answer) that's right you have the right to change the beneficiary, cash out the policy, make loans against the policy, or make any decisions about the use of dividends (Inaudible Question) ... (Answer) irrevocable (Question) do you do that when you take the policy out or when? (Answer) You can do that any time you want up to when you file an irrevocable statement; so far so good? (Question) does the person that you give the incidents of ownership to, to they have the right to transfer them back to you? (Answer) No, the question is who has the control the moment you die, if he gives it back to you then you have control then it's in your estate; (Question) right, but my question is, does he have the right to transfer incidents back to you? (Answer) sure, it's theirs, their interest or their benefits, which you may not want floating around ... "choice of beneficiaries" - give it to some Italian fellow w/a short neck & a gruff voice & you're in trouble.

-11. Next transfers for partial consideration are included in the estate - essentially that's a kind of gift - let's say you sell the business to one of the kids for less than full value, the balance of that is still in your estate - you can't automatically diminish your estate by moving the asset out at a nominal price & argue it's a sale - so it's a valuation issue - what was it worth when you sold it & did you get full value?

-12. & finally property on which the marital deduction was allowed under the QTIP trust - so if you have property coming in as the survivor interest in a QTIP trust where the marital deduction applied, that becomes part of your estate & is now subject to tax - if you pay nothing on your spouse's estate for the 1st \$600,000, now the spouse has died & you will be the beneficiary of that QTIP, that becomes part of your assets as well.

Adjusted Gross Estate

-all of these things added up represents the gross estate; the gross estate is adjusted downward to what is called the adjusted gross estate, w/2 things: 1. deductions for all administration expenses, debts, funeral expenses & what is called "the last illness expense" and 2. any deductions for casualty losses (fire, theft) - that gives you an adjusted gross estate.

Tentative Estate Tax

-from the adjusted gross estate there are 2 major deductions: 1. the charitable deduction & 2. the marital deduction - & that then gives you the taxable estate; the taxable estate has a small adjustment for taxable gifts you've made since 1976, and you come down to what's called the tentative estate tax base; multiply that times the rate & you have the tentative estate tax; (Inaudible Question) ... an adjustment for taxable gifts made since 1976 when they unified estate & gift taxes; and that gives you the tentative estate tax base, times the estate tax rate & that gives you the tentative estate tax; and then from the tentative estate tax you would deduct any gift taxes you have paid from earlier years; you also get a credit for state death taxes - you get a credit for foreign death taxes & you get a deduction for any unified estate tax credit that's still due - as you recall there's a flat deduction representing the gift taxes you might have made but didn't because you made

gifts in small enough amounts to not count; and when you're all done w/that you end up w/the fed. estate tax; relative to Mr. Clifford you don't have to worry about any of that stuff about gift taxes, get down to taxable estate & assume that's it - being an old skinflint he didn't give away a nickle while he was alive.

-notice that's a fairly detailed process, a long-term accounting process, & it presumes that during your lifetime you have kept adequate records so that you have a way of supporting lots of that, & by and large most people don't keep adequate records to support all of that, so that simply prolongs the difficulties & justifications of your program once you reach the probate court and once you start dealing w/the IRS, which begins w/the premise that you're all gonna cheat them ... (Question) in the gross estate ... if a spouse dies & the surviving spouse uses the marital deduction & he remarries, you're saying it's not available again? (Answer) that's right - so it's a charge onto the estate, gets added back, but it gets added back & then it can be deducted, in other words he adds it back to determine the gross estate, the previous credit that he took, & then after you get down to your adjusted gross estate you can subtract the marital deduction from this time around, which may have gone up, more net worth the 1st time around.

-Any questions on taxable real estate or tentative estate tax base? ... you should be aware that that becomes a major terminal point where the success of your investments & your ability to pass through the principal accumulated is going to depend.

Structuring

-let's talk a little further on structuring; a number of the more common ways of those w/property handling that property - maybe to set up:

-1. an administrative trust, what's called an inter vivos trust - you set it up while you're alive & you retain equal management or trusteeship powers w/a corporate trustee - many business executives do this because they're so engrossed in what their career may be that they don't have time to manage their own assets to their best advantage or do the detail work that's involved, so they turn it over to the bank trust dept. to manage their resources for them, and the trust may be given certain instructions, that you want to go for capital gains for 15 yrs & then you want to be able to start changing that into an income stream, you may have other beneficiaries, identifying each child when he reaches college agto to get a certain stipend each month w/which to go to school or whatever; it's not unknown that some of the older trusts (not very well drafted) suggested that Charles get \$1,000/month as long as he remain in college & we've had a number of students here that remained in college for at least 20 yrs, never quite finished ...; there may also be what's called a spendthrift clause in it & the income distributions to the beneficiaries can be terminated at the will of the corporate trustee at any time so that there is no vested interest in the beneficiary on which he could borrow or which could be attached by creditors or which could be attached for settlement of a judgment, which may be an important feature in protecting one's children, brothers, alcoholic relatives from themselves; inter vivos trust - sets up contingent plans so that at the death of the initial donor it then in effect goes into phase 2 which involves distribution to children, widows, other beneficiaries of the donor; there are no administrative charges on it, but notice because he has retained general powers of control during his lifetime the total value of the trust is included in the estate for tax purposes, definition of the estate tax, but it is not part of the estate for administrative purposes, so it does provide for a smooth transfer of management & control of the distribution function - it avoids the erosion of administrative costs, in general it avoids litigation since the ambiguities have been defined, if any, & in the mean time it provides on-going money management services by professional money managers in the accumulation process for a doctor or an executive or someone else of relatively high income, intensive concern of one thing or another; many career diplomats & others that

began w/at least some modest degree of wealth in their family often use this inter vivos trust as a way of having their property at home in continual management & monitoring while they're wandering around over seas ... the inter vivos trust; to the degree that there is going to be a tax liability, the donor must maintain separately from the trust funds suitable for the payment of the estimated estate tax - life insurance proceeds, perhaps some other emergency cushion or resources; you can provide that as the donor passes away that his spouse or eldest son or whoever else he wants as an overall overseer of the trust be appointed co-trustee w/the corporate trust, so that the family's wishes are equally represented w/the financial skills of the corporate trustee; both of them are also referred to as "sprinkle trusts", meaning that the 2 trustees can alter the amount of monies going to the various beneficiaries according to some priority schedule, so that if 1 of 3 children gets himself into medical difficulties the majority of resources can be focused on that or if the surviving spouse has an illness & needs nursing home care the principal can be liquidated to sustain them in the style & comfort to which they are accustomed; they have a great deal of discretion to optimize what they perceive as the priorities & interests of the deceased & do it on a common sense, a necessary, basis, so it doesn't have the rigidity of a will which says this is the way it will go & everybody gets 1/3 & that's the end of it, because once it's written down you can't change that; ... no matter how unreasonable the will may have been or perhaps incompatible w/circumstances as they evolved, there's no way to do that w/out breaking the will; and doing that is an unlikely task ...; so the inter vivos trust is a very useful device.

-2. the 2nd way of handling the problem is to incorporate - the incorporation provides the opportunity to freeze values in preferred stock & may also provide a device for providing continuity in management; particularly important in real estate is where you want the property manager to be skilled, familiar in the property, perhaps trained by the testator himself, & you want to assure yourself of their loyalty & continuity of employment & you can give them a partial interest in the corporate entity ... (end of side 1 of tape) ... you look at the fact that either you give 20% of the money to him w/life insurance or he's simply allowed to escape & the property loses 20% of its value for bad management & lack of continuity, well you're better off just to give it away to assure stability of vested interest of ownership on the part of the survivors.

-3. a 3rd way of handling that is to set up a 2-tiered entity, the general assets of the family go pretty much as we have looked at it before, in terms of the marital trust or life estate trust & so forth, but the major asset, let's say it's a corp. that owns a building business or a large real estate portfolio or a large farm, goes into a separate trust, sometimes called a foundation, & a principal objective of that foundation will be perhaps to provide charitable contributions; often it's a way of neutralizing the possibility of a raid, let's say we have 2 classes of stock, a voting class A, a non-voting class B, most of the assets are represented by the non-voting class B, the class A goes to the survivors & stays under the let's say the \$5M mark where estate taxes begin to be confiscatory, something like 60%, and the non-voting stock goes into a charitable trust & the income from that can then be used to support charitable purposes of the trust; the IRS says that's OK as long as the following conditions are met: 1. it doesn't represent total control of an operating business, in which case the foundation would be required to dispose of the stock in it, 2. that you disperse at least 5% of the value of the securities per yr to the charitable beneficiaries, so if you put \$10M in there at the very least you have to put \$500,000 out in cash benefits to whoever it's designed to support; if you meet those 2 criteria you can retain total voting control of the parent-family corp. & at the same time eliminate a majority of the tax, because the largest part of the asset is now a charitable donation & is a reduction against your gross estate; so you have the leverage of the assets that are represented - they are earning money from the voting stock & at the same time you retain control of the limited number of voting shares and spin off the rest into whatever daddy's charitable objectives were; this is popularized by the Ford Foundation & the Rockefeller

Foundation & a number of others, but it's done quite commonly even at the small, local level in which the estate of the deceased is set up in that way; because you can hire your own children to run the trust it doesn't mean that they don't get any benefits out of it; I know a number of major trusts where while the primary objective is to invest in medical research & so forth the daughter & son-in-law & brother & sister-in-law are each employed as trustees at \$100,000/yr to overview the estate & continue to make their contributions, so it's not a total loss to the survivors, so it's a great thing to do if you've got a son-in-law who is incapable of doing much but spend your daughter's money ...

-4. the 4th method of management of at least the major resources of the businessman is to have worked out a long-term buy-sell arrangement w/a partnership or business entity which represents the largest part of the resources, e.g. a 3 generation family has owned a resort; the 1st thing in structuring the resort has been in yrs past a twin stock freeze, the resort has then gone into joint venture w/other money partners to expand the resort; now you have g-dad & g-mom having given the common stock to their kids, now their kids are coming along & running the resort (3rd generation), how do you extricate the middle generation? one of the things is that g-dad & g-mom can leave the remaining callable preferred to their g-children so it would skip a generation, that would be one way of doing it; another way of doing it would simply be to create a buyout arrangement whereby any one of the partners that dies in the venture, either the outside family interests or inside family interests, would have say a 10-yr buyout period in which they would just receive 10% of the net operating income & 10% of the capital assets sold during that period of time; it's attempting to recognize that the momentum created by many yrs of service & input by those people must be rewarded by successive returns out of business rather than simply a 1-shot settlement; the hope is that the asset will be continued as well by the survivors & will continue to appreciate as they receive the money, which is in essence a partial liquidation over a 10-11 yr time period, they will get more money than if they simply got the present value of the estate right now, which may be at a point where if they had just gone into straight debt the net worth is pledged to secure the loan, were they to have to cash out one of the partners at that time it would be relatively stressful & a technically insolvent kind of situation, so you design a long-term buyout of the deceased partner's interest from the income of the partnership; part of that requires some evaluation of how well the partnership will survive, what kind of momentum it has, obviously if there are only 2 partners & 1 dies his estate doesn't his estate doesn't want to wait too long for the payoff because partner #2 may also die and "the goose will stop laying the golden egg altogether", but on the other hand if it's a hard asset kind of business that has 25-30 yrs of momentum going & an executive-management force in place, you can take a much longer term to amortize 1 of the originator's interests out of the property; there are a good many major businesses today that are still in the process of amortizing the estate value of one of the early partner-originators of the program; that's also useful where the deceased contributed certain patents or other kinds of resources of that sort which have a longer-term payoff, rather than having a royalty agreement directly w/them because at that point the value of the royalties & the patents contributed to the corp. have to be paid for over time by a long-term contract.

-those kinds of arrangements, any one of the 4, are most significant where the estate consists of assets likely to appreciate if well managed or likely to be wasted quickly if not managed well, which certainly characterizes real estate; for the real estate investor in the past one of his real problems was finding corporate trustees who were willing & able to provide that entrepreneurship that was presumed by his real estate investors; a banker said last summer at the banking school "we're trained to paint & sell it, that's all we want to do w/real estate", it's not as easy to handle as bonds & stocks; we never know

how we're doing & there's no place to look & every time we do look something horrendous is about to happen; so since then some banks have developed very good real estate skills & charge for their services w/a whole listing of things they can do for you for a certain price; and it's really critical to draft a will that picks in advance who the corporate trustee is going to be & who w/in their staff is going to be responsible for the assets, & them giving them the power under the will to do what needs to be done for the real estate, exempting them from liability for loss & providing incentive returns where they succeed; the old trust fee of 1% or 1 1/4 %/yr is being replaced by a series of incentive fees that look at acquisition management & disposition, minimum rates of return in terms of cash income or bonuses; if they exceed that then look at overall rates of return after 10-15 yrs when the properties are sold or reappraised, & to the degree that you have an average annual return in excess of a real rate of say 6% & in inflation rate, the trustee gets a percentage of that; this has been a long time in coming and there's a great deal of resistance still in many of the trust circles to having incentive fees for fear that that will be an incentive to take riskier positions w/other people's money & perhaps to churn a little but to earn the higher disposition or acquisition fee & so on; that remains to be seen, but the Comptroller of the Currency & ERISA have both modified the position over the last couple of yrs to permit that type of incentive contract where you have entrepreneurial assets like real estate to manage; several of our major building & landowning firms are now in the hands of bank trust depts who find someone they feel has the skills appropriate & appoint them the chairman of the board & they become the overseer of the operation, which then goes on for yrs w/out public recognition that technically the control & managerial power is a corporate trust division of a bank.

Vehicles

-OK, for structuring we talked about the vehicles for the trust, the creation of it begins in 1 of several ways; these are not mutually exclusive, probably all of these instruments will exist at one point or another.

-1. 1st is the will - the will will be a very detailed plan for establishing administrators, the probate processes, the assets' ultimate disposition & most importantly for providing the powers necessary for those who survive to execute the plan; the presumption of the statutes is that you have no powers to go forward w/a continuing business & in the absence of anything to the contrary you turn it to cash & distribute the cash under the terms of the will (not the assets, the cash) so throughout the will is being designed not only to provide positive instructions to those who are expected to carry out the plan, but at the same time to frustrate the way in which the statutes work to achieve something entirely undesirable or unsuitable relative to your plan; if you die intestate the way the statutes work essentially if you have a spouse & child each gets 50%; if you have a spouse & 2 children the surviving spouse gets 1/3 & the children get the balance prorated between them; if you have 3 kids, mom gets 1/3 & the kids each get a 1/3 of the 2/3rds; if 1 of the kids have died & he has 2 kids they would each get 1/2 of what that original child would have had & so forth; that may mean if they're all under age each one has to have his own guardian, which is an expensive proposition, greatly complicates the operation, & it may mean the working control of the business is gone; a friend of mine, his father died intestate, he was the controlling interest in a major corp. in Milwaukee; by the time it got divided up among the wife & 3 children, 2 of the guardians named for the children were unfriendly to the existing management of the corp. - they had a Donnybrook - ultimately he had to quit college & take over running the business just to sort out the family feuds that were going on; so the 1st instrument is the will & it has to be a very carefully drafted statement of intent as well as a statement nullifying the operating of the local statutes that govern inheritance.

-2. the 2nd element is going to be cross-purchase arrangements w/business

associates for 2 reasons: 1. the estate of the deceased needs cash & 2. your associates don't want to be in business w/your relatives; you were dandy as far as they were concerned but they don't want anything to do w/your relatives, they want to go their own way; so you need a mechanism for disengaging at the same time that you create liquidity.

-3. a 3rd element than needs to be drafted & at least ready to go into place if not already operational are the trust instruments which will control the ongoing objectives of the will.

-4. the 4th major piece of work will be an ongoing inventory of assets, other property rights (e.g. the survivorship rights in a life estate of somebody else, life insurance), all the various things that make up a gross estate maintained at a reasonably current level, w/the documentation for all that at a central point protected against destruction & violations of privacy ...

-(Inaudible Question)... yes, the trust instrument probably would be drafted, even a marital deduction trust or a QTIP trust, the wording of that would be in place even though it doesn't become operational until the funds are actually transferred to the trust, but you as the testator want something to say about how that's going to be done so now's the time to do it.

-finally, it would be good for the donor or testator w/considerable means to provide some sort of further direction as to his intentions, priorities, charitable objectives, etc.; too often those are either cryptic or impossible to recall by the survivors after the fact, & yet they're sincerely interested in carrying out whatever the wishes of the testator were, & therefore some sort of essay that is non-binding but directional can be extremely useful; & it's amazing how many people don't do that; it also goes w/out saying that both spouses in a married couple or all partners in a given business should have executed something in a similar fashion.

-since the marital deduction is such a significant factor many wills contain what's called a survivorship clause which is a presumption of survivorship; the marital deduction may be an extremely desirable device in terms of cutting taxes & getting the assets passed through to children, trustees, guardians & so on, so where there's a "common disaster" (sometimes it's called a common disaster clause), there's a presumption that one party or the other, husband or wife, died 1st, depending on which serves their estate purposes best; therefore if there's an airplane crash & though the husband survives the spouse by several hrs., the will can reverse that back over a period of I think 24 hrs., & treat the whole process as though the wife died 1st & therefore the contingency clause comes directly into operation; or you can presume the husband died 1st & a marital deduction moved to the widow for a matter of moments before it then gets distributed, thereby salvaging the property tax interest that might have been there.

-so there are a variety of details that must be attended to in the structuring of the plan, & real estate makes it particularly important that you do so, & at the same time gives you more diversity of planning techniques because of its joint survivorship, because of the way in which you peel off different interests in the real estate, the land going to 1 party, the bldg going to another party & perhaps life estates going to the occupant, residual estates going to those who are going to inherit the farm; the amount of flexibility in real estate is perhaps greater than any of the other investment media, therefore real estate creates its own estate problems but at the same time it provides more opportunities to solve estate problems than virtually any other asset.

Real Estate 850

3-7-1988

Transcribed by Evan Harrison

Discussion of Returned Problem Assignment: In looking at any RE investment, as in any kind of analysis, the 1st thing you should do is set up a time line and lay out some points on the time line and ask "where the hell are we?" What has already transpired that can't be undone? Where am I coming in on the life cycle of this investment? Two of the tenants in the case got rent concessions. But that is in the past - it doesn't matter to you. By the time you're coming in on the scene, they're paying the face amount of rent. From an accrual accounting basis you would take the ave. dollars paid per year. This is one of the major problems RE has with accrual accounting. If you are buying an investment on the cash flow, then match when you get the money to what periods you're talking about. It is very useful for any kind of analysis to block out a time line.

Critical flaw #2, is that a lot of you had a problem w/ rent stops and what that does to the cash flow. You were quite right saying that the market was quite strong and assuming that land costs & const. costs had risen, you should flow up to a more normal occupancy. Some of you not only bumped the rent, but eliminated the stop. The tenants are paying whatever is above the stop. Some of you dropped the stop to \$4.00. You had a little problem in terminology. Some of you went to no vacancy.

Some of you had a problem with the venture capital firm, saying it was high risk. Not so. Venture capital firms are very liquid organizations. They make loans to other start-up companies, and have lots of capital of their own. You talked of a guarantee - from whom? The tenant is already in there. The developer is going to take the same approach and refuse to guarantee what is essentially a national credit, or if he must, want \$1,000,000 more for his building.

Most of you are pretty conservative. A few were very aggressive. I can tell the brokers right away from the former auditors for the FDIC. You now have the Clifford case to chew on, and we're going to hand out the fourth case soon. It will be due on the last Mon. of class, and Jim Huffman will be here from Eastdill to go through that with you.

Q. on Clifford Case. A: that should be 300,000 life ins. on the next to last page.

Q. On RE 769. A: Schedule is in place and we have an all star cast of thousands. (Discussed indiv. presenters)

GROUP INVESTMENT AND GROUP RISK

By way of introduction to the next phase of the course, which has to do with portfolio structures for RE. The Phoenicians were the first to develop the group investment concept as a way of handling risk. They sent their ships out on trading expeditions with underwriting shares. The term underwriting comes from that. They would put out an agreement and you would sign for a percentage of it below the agreement. That was picked up in marine insurance in terms of the way Lloyd's of London, etc. operate.. The concept essentially was don't risk more in a single venture than you can afford to lose assuming total loss of your entire investment in that enterprise. If you then made enough investments, then that ship which did return or RE investment which did survive would provide sufficient return to:

1. Recapture your capital, and
2. Provide a return on the total amount of money at risk.

TYPES OF GROUP INVESTMENT

All of the various forms of group investment grow out of that philosophy: diversification by buying a small divisible investment which is of no greater size than you can afford to lose. In RE that breaks down into the following kinds of investments:

1. The General Partnership. The problem is that the General Partnership with its full liability really doesn't break the investment down into small enough units. You can conceivably be liable for the total project even though you are only a partial investor in it.

2. The second more likely way of doing that is obviously the limited partnership.

3. The third way is the corporation. As you've already learned, there are essentially two types of corporations, but there can be as many as three which can be utilized.

One is the subchapter S, with very limited applications to RE, except for land dev., resort hotels, and restaurants.

Number two would be the standard corporation.

Number three would be the incorporated trust, REIT if you will.

4. Then there are two additional trust forms for investment in Real Estate.

The first is the classic REIT, Massachusetts Investment Trust, which is non-incorporated.

And two, the land trust, which is available in maybe a dozen states or so, such as Illinois, which will define a series of beneficiaries and their appropriate shares in whatever is owned by the trust.

5. Recently we have begun to see three new institutional formats.

One is the so-called open end commingled fund, which is a general trust form of ownership, essentially, in which the investors receive certificates of beneficial interest. Generally associated with pension funds, but it doesn't have to be. It could be associated with endowments and other forms of non-profits.

The second type of collective pool is the closed end trust. It essentially has a finite life - nobody gets in past a certain date and nobody gets out until all the assets are liquidated and there is

a distribution to the beneficiaries.

The third type of collective investment is a whole variety of so called loan participations.

Notice we did not talk about a REMIC. A REMIC is not a form of organization. It is any one of these organizations which is managed to qualify as a REMIC in the tax law. A REMIC is a critter of the tax law, and has nothing to do with its legal organization. It could be a corporation, it could be a trust, it could be an REIT, it could be a limited partnership. All of them, if operated a certain way and if meeting certain requirements, could be a REMIC. So do not confuse REMIC with a legal organization. It is a tax qualification.

CHARACTERISTICS OF THE GROUP INVESTMENT

Each of the different formats have to address very specifically the following items:

1. Liability of the investor for losses beyond the original investment.
2. Allocation of managerial control.
3. The time window for purchase.
4. the time window for liquidation.
5. The frequency of reporting.
6. Who is eligible to invest.
7. Investment policy.
8. Regulatory policy.

For example, an REIT that is traded on the open market, the time window to get in and to get out is generally continuous. With an open ended commingled fund it is generally quarterly. The management of the fund can decide whether to accept your investment or not, and moreover, put you on call as to whether they will pay you off or not. A decidedly different window of investment and window of liquidation. On a closed end fund, you can get in before a certain period, and after that, bang, it's closed, no further investments accepted, thank you. It will generally be marketed to say, "the minimum we are going to go for is \$100 million, and we will accept investments up to \$150 million. If by that certain date, we only have 90 million, you get your money back, and there's no deal. Once we hit \$150 million and its oversubscribed, everyone gets to invest a proportionate share, so if it goes to \$200 million and you put in \$10 million, your share would be 3/4 of that, or 7.5 million, instead." You don't get out until the liquidation of the fund, and that window is generally very broad, they say "We will liquidate the tenth year, or up to the thirteenth year." So they aren't stuck with having to liquidate when the market is at its low point, or some other condition suggests they can't do that, or some building takes too long to sell. So they have a very wide window for exit, even though there's maybe only a month wide window to subscribe and fish or cut bait.

Q. Do they load any risk factor into that for the fact that you can't get out when you want to.

A. That is the subject of considerable debate, as we shall see as to which is riskier, the open end or the closed end fund.

Next thing we need to decide is the frequency of reporting. If it is a bank managed fund, technically, it must report monthly. By

convention, REITs, etc. generally report quarterly, but they don't have to, they can go 6 months. Almost all of them report annually. But once you go to a closed end fund, they may not have to report changes in the capital value, as opposed to operating statements of revenue and expenses, more than every three years, arguing that there is no way to take the temperature of the real estate every year and have an accurate sense of what values may be and so forth. So they get to establish the game.

Next, who is eligible to invest. This is going to reflect a number of things. The minimum size of a unit, obviously. Second, the category of the investor. What do we mean by category of the investor? Well, we have investors that are subject to ERISA. ERISA has distinct rules as to what they can do and can't do, and the tax laws have some things to say about when you qualify and when you don't. However, a public employee retirement fund has much more liberal rules about what they can and can't invest in. Public employee funds can invest in everything ERISA funds can invest in, but ERISA funds can't invest in everything public funds can. Play with that one for a while. On the other hand, endowment funds of eleemosynary institutions can't invest in what public funds invest in, because they're under a different section of the code which is somewhat more stringent, particularly relative to leverage and relative to the at-risk rules which could make them subject to taxation. Then, of course, we have private individuals and consortiums of private individuals. As you saw in the REIT rules, we saw that 5 people can't 50% of the deal, and there have to be at least 100 investors. So suddenly you get locked into a position where if you get 1 more from a family, under the attrition rules, bang, you just blew it, because then 5 families have 51% of the deal and you just blew your trust cover. So there are a variety of qualifications as to who is eligible to invest.

All of this precedes what the investor really asks about: "What is it that we are going to invest in?" Some of these rules you can make up for yourself. "This fund will only invest in office buildings that are less than ten years old." Or, "We will not invest in buildings which are under development, which is defined as any building with less than 80% occupancy." Those are arbitrary, but they reflect the investment policy of whoever is running the fund.

There may be other controls. For example, in the pension area, you could not invest in something in which the parties in control had a vested interest. If they are an interested party in the transaction, it would be regarded as an illegal transaction. If you make an illegal transaction, several serious things happen: 1. There is a tax on the gain which is totally confiscatory, so if you sold your 1 million dollar building to the pension fund in which you were also one of the investment managers for 2 million dollars, you had a 1 million dollar gain, the federal gov't would take the entire gain. And 2., if the board lost any money for having engaged in a prohibited transaction, the board personally would make up the difference.

So we have some things which are a matter of investment policy and some things which are a matter of regulatory policy which begin to define what we can invest in and for whom.

Those regulations can come from multiple sources:

1. Federal rules controlling pension fund investments.
2. IRS rules controlling tax exempt investments.
3. Enabling legislation controlling public investments.

The city of Milwaukee says their pension fund cannot invest outside the continental United States. That's their rule. Maybe good, maybe bad, but it's their rule. They cannot invest in development properties. They will invest 5% of their assets in Milwaukee. They're legislated, but singular to a particular turf. One of the big rhubarbs you hear about currently is 'should a pension fund be a social investor and a development bank for its own state, etc. You have that continual tension between legislators who would like to serve their own purposes and investment managers who say that's a lousy idea, because you lose risk management control, and we're watching that happen in Wisconsin right now between the investment board and the legislators. The legislators would look pretty silly if the Investment Board had knuckled under and done what they wanted and put \$200 million into the Chrysler plant of teacher retirement funds. If they had succeeded on that one, the idea of social investment would died right there. It might have been worthwhile.

THE LIMITED PARTNERSHIP

Let's ignore for the moment the general partnership, and treat it as a special exception to the problems of the limited partnership. After all, no one wants general liability on the project, let alone for whatever their partners do, unless there is some overriding compelling reason which makes that exposure more attractive than the next alternative which is the limited partnership. So let's talk about limited partnerships.

PUBLIC DISCLOSURE RULES

Limited partnerships have been around for a long time. They are a product of the statutes. The basic bones of the statutes in all states, although each state differs slightly from the uniform partnership acts which have been promulgated to standardize the process are:

1. The limited partnership must be registered at the register of deeds office under the misc. category in any county in which it does business or owns property. The purpose of that is to put creditors on notice that, 'while there are a lot of folks involved in this deal, here is the exposure of each of the limiteds, and here are the generals to whom you must look for general credit support, and here is the current roster of general partners and limited partners in the project. The partnership then must file its partnership agreement, which identifies the gen. partners and their address, etc., and then lists the limited partners, and their address, etc., and the % of their relative participations. The generals have 5% each, let's say, and the other 85% is the limited partners, and how many of them are involved in each one. Why is that important? Well, one thing that terminates a limited partnership is if 51% of the limited partners die. If you have 1 limited partner with 51% interest, you'd better watch him closely, because if he dies, poof, the whole thing is in dissolution. The only way out of a L.P. is for someone to have his name removed from the public roster. You may do that, even though you don't get any money back. You may see the whole thing going down the pike in another year or two, having a negative basis, foreclosure on the mortgage causing you a disaster, etc. You may abandon the partnership simply by going to the G.P. and asking, requesting, and demanding that he remove your name from the public roster. At that

point you are no longer a L. P., you have no claim on the partnership, you get nothing if it is dissolved, but on the other hand you don't get bit in the tail of it goes into foreclosure, either. The only other way out, as John Ridass (?) puts it so delicately, is to put it in your wife's name and get a divorce.

Q. If there is limited liability, why would you want to get out of it?

A. There may be limited liability as far as the investment is concerned, but not with IRS.

Q. If there were periodic cash calls and you wanted out before all of them were due, what would be your liability to pay?

A. You can get out of the L.P., but you would still have to pay. You cannot avoid the subscription price. Now what you would have to do is attack the organizers of the partnership on the grounds that there was securities fraud or it was misrepresented or there was mismanagement of one form or another. That is happening all over the country. Some people really had to make that decisions. In many cases their attorney advised them to go fight it - to attack the G.P. or the securities underwriter on the grounds that there had been some sort of breach in the execution of the partnership, and in essence extort a release from your restriction, because in general the G.P. would have to decide whether they would want to be in public being accused of securities fraud or just buy you off and hope you go away. Just raising the spectre of a public spitting match about that may be enough to get the people to give you the money back and let you off the hook. With the change in the tax law, there was a good deal of that going on.

Now, the other elements that would be involved in that agreement would be the subscription agreement. How would the L.P. and G.P. fund their requirements. In many cases they could go as long as five years to collect all the money, and the hope would be that the tax savings on other income would be sufficient to fund the subscription, so you weren't really using real money after the first draw.

One of the problems, is what kind of sanctions (and this would be part of the subscription clause) there would be against a partner who does not meet his subscription. There were two major answers to this.

One, there are some companies who will guarantee the timely payment of the subscription. MGIC had a partnership group that did that, Continental Casualty, Travelers Insurance, a number of others are providing, more cautiously now than before, in effect a credit enhancement which says in effect "no matter what this limited does, we will pay and then we will go and extract it from him." The creditors get the feeling therefore that the money will be there when it is needed by the project, not because Joe Smorgasborg says so, but because Continental Casualty says so. And that's a AAA credit, etc.

The second alternative is to simply convert the L.P.'s position to subordinated debt to a long time fuse. The courts will generally not allow you to simply confiscate the partners interest, general or limited, because he didn't meet his next obligation in funding. He subscribed for \$50,000, he's got \$20,000 in it and thinks he made a mistake and he doesn't want to make the last 3 \$10,000 payments. They say, O.K., Charlie, in suing you for breach of contract for getting into a spitting match about that, in the meantime, your \$20,000 no longer makes you a limited partner. You lose all rights as a L. P. and we're going to give you a \$20,000 subordinated 3rd

position note which pays 5% interest per year and is payable in 15 years. Then you've got a pretty worthless piece of money. But the creditor feels better, because he knows that whatever money was in is going to stay in. So those are the two methodologies for meeting unpaid subscriptions.

The last major area is dissolution, and that can be subdivided into three categories:

1. Voluntary dissolution. L.P.'s under the IRS rules and the Limited Partnership Act have only three decisions in which they can participate:

1. Refinance

2. Replace the Limited Partner because he is incompetent

3. Dissolve the partnership. That's voluntary. If they vote to dissolve, the G. P. has to follow through on that and go into a dissolution mode.

Q. Does it have to be a 100% vote?

A. No, generally it is on a sliding scale. Say 100% to replace the G. P., since he drafts this thing and he wants to make it very difficult to replace him, 75% to dissolve, and 65% to refinance. In other words a different percentage.

Dissolve may also include merger. We'll roll up our partnership into a Master Limited Partnership or a corporation or something like that. That would technically be a dissolution.

2. Second kind of dissolution. The General Partner says "I don't want to play anymore." Nobody can be forced to be a G.P. against his will. So the G.P., generally w/ some kinds of contractual limitations like he has to stick with it three years or five years, or he has to complete construction, but with some prequalifications with respect to the fact that he must finish now that he has started the job, he can go out at any point in time. He may have several qualifications for that. He may 1. buy out all the limiteds according to some pre-set appraisal formula, or 2. he can just say, enough of this, we're going to dissolve it, or 3. he dies. Now this may make his investment unmarketable if it is too vulnerable. In order to make it a marketable L.P. in which other folks want to invest, they need some stability - they don't want a surprise dissolution which may hit them at a very vulnerable time relative to the tax law. They've taken all of the investment tax credits for the personal property and they've used accelerated depreciation, and they've just taken a big chunk of tax savings because they've donated the facade of the building for historical restoration, and now the G.P. says "hold it." All of a sudden they have to pay ordinary income tax in year 2 on all of the stuff they've just taken a deduction in year 1. Obviously that's not a good thing to do, so obviously they want control of it. Well if it's wide open on the part of the G. P. to take a (?) powder, obviously that's not a good thing to do. So typically you try to put some constraint on his mortality. So typically the G.P. puts 5% in his own name and 95% in a corporate name, so if he dies, the corporation still lives and can keep the partnership going. You'd be surprised how often locally in the earlier days a G.P. put his interest only in his own name and then suddenly died, immediately, thoughtlessly and inconsiderately to his investors. That's a mess.

3. The third kind of dissolution is when 51% of the Limited Partners die. Otherwise, if only one dies, representing, say 10% interest, there is an automatic restructuring of the partnership, as

we talked about in estate planning earlier, or 2. the estate gets a note for the value of the share or 3. the L. P. is assignable to the estate or heir of the deceased, while it would not be marketable. Notice that there is a difference there. Most L.P.s have a very limited marketability initially, but an assignment to an heir would not be a marketable instrument. So it could be turned over to the estate, even though the estate couldn't sell it to somebody else.

Q. Would the rights go along w/ the assignment.

A. Yes, it would survive as a full L.P. interest, including voting rights.

The above are the basic kinds of information which have to be in the public disclosure. You follow that and you now have a Limited Partnership.

INTERNAL REVENUE SERVICE RULES

The Internal Revenue Service has a couple of requirements of their own, however, which are not part of the Limited Partnership act, but which represent significant constraints on it.

1. To be a single tax conduit, and a non-corporation as defined by the IRS, you cannot have more than two of the following four attributes. (Technically 6 attributes if you include that there have to be 2 or more investors and they have to be in it for a profit. Obviously there will be 2 or more investors, the G.P. and the L.P. They cannot be the same person, although the G.P. can invest up to 10% in the limited partner. So you've got to have 2. So the first 2 criteria are kind of a given.)

1. Centralized management
2. Limited liability.
3. Marketability of shares.
4. Immortality or continuity.

Notice that a corporation with marketable shares has all four attributes. The board of directors elects somebody to run it; he's called the president - centralized management. The shares are marketable, there's limited liability since the shareholder can only lose what he's paid for his share, and presumably can market his share indefinitely, and the corporation doesn't die even if all of the shareholders do.

Those are all of the attributes that everybody would like to have, but don't want them so badly that there would be double taxation. So the trick is, how do I creep up on every one of those four, without crossing this rather vague line as to when a group of us become a corporation or an association taxed as a corporation.

Looking at the Limited Partnership, what do we have? Well, the first thing we have almost by definition, is centralized management. The general partner is a centralized manager, and the L.P.'s are not even permitted to manage, or they lose their status as L.P.'s. So we have centralized management, and there is nothing we can do about that one.

What can we do something about? Well, one is immortality or continuity. Almost all Limited Partnerships have a clause in them which is a sunset feature which says if we don't dissolve before then, we will dissolve on April 7, 2007, or whatever, and poof, you are now not immortal. How far you can push that out is obviously a big rhubarb with the IRS.

The next one is limited liability. The rule is that everyone has to be equally liable. That means that either nobody is liable or everybody is relative to the capital debts of the organization. For example, if we write a non-recourse mortgage, so the only remedy of the lender is to take back the property, then everybody is equally non-liable relative to that debt. The general partner is always liable for the trade credit. But what if he gets a second mortgage on the property and the G.P. has to sign on the second mortgage as a condition of getting it, but the L.P.'s don't. At that point we no longer have equal liability, because all of them are non-recourse on the first, but the G.P. is full recourse on the second. At that point the IRS says you drop back to the at-risk rules and the L.P.s only enjoy tax deductibility for interest and depreciation only to an amount equal to their actual investment at risk. They are trying to discourage a situation where everybody says, we're all non-recourse officer, none of us were driving, we were all in the back seat. But recognizing that the G.P. would try to avoid that exposure by creating a corporate shell in which there are no assets in the corporate shell, the next rule is called the safe-harbor rule, and this is what puts the clinker in the general partnership.

The Safe Harbor Rule says that the G.P. must have liquid cash resources equal to 15% of the cash raised for the equity side available to the partnership. So there is real substance to the fact that the G.P. in essence is liable for something and can stand to lose something. Otherwise everybody has limited liability. The limiteds haven't signed on the mortgage, it is a non-recourse mortgage. If the general doesn't have anything in the shell corporation, he can't in fact lose anything. You now now have limited liability for everybody, and that's a corporate attribute. Again, with that third corporate attribute, you're a corporation, and if you're a corporation, you get taxed like one.

Finally you have to have marketability to be a corporation. So most partnership units have very circumscribed marketability. Many of them say "I'm sorry, but you can't sell at all for 5 years or 10 years, or something like that." Others state that in order to sell your share, you first have to offer it to the general partner, and he can buy on some scale, so if you offer it in year 1, you get 75% of what you invested, in year 2, maybe 82.5%, in year 3, 87.5%, etc. And the general isn't obliged to buy it if he doesn't want it. Assuming he doesn't want it, the next condition says you have to offer it to all of the other limiteds so they can maintain their pro-rata position. If they turn it down, then you can go and offer it to the general public. So it's a real restriction on marketability. If you don't have that, then it's a corporate attribute to be able to sell your unit, and you're going to be double taxed.

So the IRS has created a significant number of limitations on what you could do with a limited partnership but you can't if you want to maintain the single tax conduit element.

SECURITIES REGULATIONS

The securities folks have gone even further to provide additional limitations on the Limited Partnership. A limited partnership is a security. **A security is defined as any fractional investment in an enterprise run by a third party for the profit of**

all. That clearly covers a limited partnership. Therefore you are presumed to be a security unless you can meet certain exemptions under the security act. But those exemptions must be applied for and determined explicitly. The failure to do so means the G.P. or whoever structured it - generally the G.P. - is guilty of securities fraud and the investors are entitled to their money back with interest at any time they so determine that such a fraud has occurred. Furthermore, if they don't get their money back, you get to go to jail and think about it some more. By and large the SEC attorneys are very good, and most of the people who violate this rule do in fact go to jail and have a chance to think about it some more. So as a result you don't want to cross either the state blue sky laws or the federal blue sky folks at the SEC.

Now part of their requirements are who is eligible to invest. We'll talk about schedule D, etc., later.

THE GENERAL PARTNERSHIP

Now the limited partnership begins with some very real constraints on those who would use it and apply it. At that point the general partnership doesn't look so bad. The general partnership has everybody involved in management, and is therefore not a security. It is not an assignment of fractional interest to be managed by a third party. All of the parties at least theoretically have equal say in the management of the enterprise. Second of all, because it is mortal, there is no limit of liability, and there is no centralized management, and the G.P. can't sell his interest to somebody else, because the remaining G.P.'s can't be forced to be a G.P. with somebody they don't want, it can never be a corporation, and will never be subject to a double tax. The third major advantage to a G.P. is that because it is not a security and doesn't have all of these technical rules, you can start it instantly. You and I can decide we are going to have a general partnership, open a bank account, each put in \$5, and we are in the real estate business. We don't have to know what we are doing, we don't have to know what the budget is, we don't have to make anybody any promises as to the general area we are going to invest in. If the following morning we wake up with a hangover, and want to reorganize it, You're going to do all of the work and I'm going to go along for the ride and only critique on the management, etc., and you get 80% of the profits and I'll take 20%,. you can do that. You didn't promise anybody anything, therefore there is no paperwork to change, etc. So for that reason the G.P. looks good relative to the L.P., but you'd better know who you are in business with, because you're liable for his mistakes as well as yours. By the very nature of the G.P., the creditors can come after both of you, or they can come after you because you have \$100,000 and he doesn't. How you collect from the G.P. his 50% of the mistake, that's between you and the G.P., not between you and the rest of the world. So with that little exception, general partners are really fun to work with, but I don't know very many people I would want to be a General Partner with.

NOTES 850: Monday, March 21, 1988
Prepared by Chris Quinn

I Limited Partnerships: until recently, very popular in structuring single tax conduit entities.

A. need two persons: a General Partner and a Lim. Partner

B. Must register with Register of Deeds in county of principal place of bus.

1. Certificate must have a summary of all agreements
2. (great prospecting device for syndicators to find out who's making what deals and who's investing)
3. If additional shares are sold, an ammended certificate must be filed. Primary purpose - to put creditors on notice, for liabilities and debts
4. Must include:
 - 1 Name of partnership
 - 2 Character of the business (farm, oil, cattle).
 - 3 Location of the business
 - 4 Name and residence of every GP and LP.
 - 5 Term of the partnership
 - 6 Cash & or properties contributed by each partner. (\$, land, skills etc..)
 - 7 Any further contributions which might be called for (assessments and maybe penalties for non-payment. All this helps creditors get a better picture of the deal)
 - 8 Time frame that the contribution of LP has to be returned (if any).
 - 9 Terms of profit distribution: % of what?
 - 10 Provision for "assignment" of limited partnership. Typically no sale provisions due to non marketability feature of all lmt'd partnerships. Possible sale to other members but usually with penalties
 - 11 Any rights to include additional Lp's
 - 12 Terms of priority of contribution and compensation of Lp's and GPs.
 - 13 Do Lp's have right to receive other property besides cash (paid "in kind")

Generally, an amendment must be filed when a change of purpose, partners, financial relationship between the partners, occurs.

C. LP's have 3 possible decisions to make:

- 1 to dissolve the p-ship
- 2 to refinance the p-ship
- 3 to get rid of GP - malfeasance or incompetence etc..

D. The GP is a fiduciary and as such exposes him to litigation from LP's. This is a major risk

He acts and reports as a ~~Fiduciary~~

Second major risk for GP is that a LP'ship is an investment ~~security~~. The question is: Must it abide by security rules?

Answer: Yes, unless it has an explicit exemption from it, vis-a-vis certain technicalities of inter or intra state cps.

- None the less the GP must apply for and receive the exemption
- (D.) In the past many GP's didn't understand their obligations and ended up in costly litigation.
- E. The need for complete information about the project compiled for prospective investors means that the GP must have everything accomplished before writing the prospectus; appraisals, accountant info, financing etc., all of which is very expensive. So: sunk costs are high
- sellers had long waits (6 - 9 mos.) for their \$ and charged more for that time value
- Third big risk to GP

- This means they couldn't move quickly on an acquisition, implying that the properties weren't always top notch.
- F. In order to pay for all the upfront expenses, the syndicator (GP) had to charge a variety of fees allowing for a first year write off. He also could structure financing with a false mortgage constant (from 12% down to 9%) and pay
- [he defines in, he could double dip on that basis. If he]
[he defines in, he could double dip on that basis. If he]
The balance due after, say, 5 yrs. Obviously, he was hoping that the project would appreciate in value which occasionally didn't occur. More often than not the LP's weren't told about all this. If the project failed to meet the debt, and the LP's found out about the false constant tactic, the GP was really screwed!

II. Concept of profit sharing: % of what?

- ** The definition of return is the critical element of the prospectus. E.G.: a LP getting 5% of taxable income isn't the same as getting 5% of net profits.
- A. Whereas a GP doesn't have such a large interest in the future value of the building and would rather "milk it" and get his piece of cash available for distribution before returns, while the LP's have a vested interest in the resale value of the property, and are also the ones who pay to refurbish and renovate, so they want the GP to take his 5% after distribution for reserves. But now the GP has to postpone getting his cash, so he'll want some other participation elsewhere.
- B. "What if he (GP) gets a part of cash avail. for dist. before res. plus the amount of that years principal pmt. on the mortgage debt? Is that a good deal? See, net profit is before you pay debt service and the GP would love to share on a net profit basis, then the mortg. comes out on the Limited's side and there's nothing left for distribution. The GP has taken his share up front and the LP's take all the risk that they'll ever get the principal back. So, 95% of nuttin is still less than 5% of something." (Dr. G.)
- C. People often didn't read the prospectus which the GP wrote, and therefore didn't see that his profit share was based on something different than theirs.
- D. GP's also often own the leasing, general contracting and land syndicate companies, so they are taking those profits too. Now if he takes 5% of gross income which he already got that in

- property management fees, the excesses get a little blatant.
- E. "How bout cash avail. for dist. after allowance for reserves , plus the tax liability for shelter benefits of the taxable income calculated on a specific tax bracket? The GP says "you guys (LP's) are getting 95% of the tax shelter, we really ought to add that back in. So if everybody is in a 50% bracket, then we'll take that cash after reserves, which is fair enough, but now in addition relative to the LP's we'll add back the tax benefits you're getting and then I'll (GP) get 5% of that because I'm not getting the tax benefits that you're getting."
- F. "Ultimately what you're really interested in is cash after reserves, (which is fair, you've paid off the loan and set aside money to involve the property) plus the tax liability or shelter benefits of taxable income calculated for a specific bracket, plus the amount of principal on that years mortg. debt. Is this a good deal for the GP or the LP? Isn't the GP at that point already getting his share of resale price? The net proceeds on the resale include the pay down on the mortgage, but he's getting it up front already - 5% while they own it. Now if we look at what our sales proceeds that he defines in, he could double dip on that basis. If he now gets the cash left after the repayment of the mortgage on the back side, he's double dipping, he got 5% on the mortgage pmt. in aid, while they were making mortgage pmts. and now he gets 5% of the net worth on the back side after the loan is paid."

Who gets paid when is the critical element of the profit distribution plan. A 95/5% split , alone, tells you nothing unless you know from what accounting line it comes from.

III. Sales Proceeds

- A. Should the GP participate in gross sales? The LP's won't ~~want~~ want him to since there will be a number of charges taken out downstream such as closing costs, and sales commissions.
- B. Some GP's might get a piece of Net Sales price
- C. Or they might get the above minus the beginning mortgage balance.
- D. Or he might get paid for performance. ie: Net sales price minus the purchase price, and therefore the capital enhancement of the deal will be shared. But then the GP complains that that isn't a 5% deal since he's only participating on the upside, and therefore he should get 25% of the difference. The philosophy: You get to name the base, and I get to name the percentage!
- E. Another possible base is all cash received on sale after pmt. of the mortg. balance at the time of sale, including a refund of working capital and unused working reserves and unallocated reserves, to the LP. That would be fair since the reserves were withheld from the LP's as well as the working capital.
- F. Still another is where the GP gets 1% of the original value of the assets=s (why the original value? This keeps the GP from

- (F) being too aggressive on annual appraisal values thereby increasing his take). Then the investors would get , say, a 7% fixed return plus an annual CPI loading (e.g.: 7% plus a 4% CPI = 11%). After all investors had gotten their real return of 7%, then you subtract it all from the total sales proceeds and any surplus goes to the GP/LP on a 25/75% basis respectively.

The idea is to know what accounting line you're on and how you define the base and what the "wiggle room" is in that. Don't end up paying twice by giving a cut of operations and another cut of sales proceeds. E.G.: "Don't reward the GP for making mortgage payments which he was supposed to do anyway and then give him a reward in addition to the build up in the equity position as a result of pmt. on the mortg.. That doesn't make any sense at all." (Dr. G.)

IV. The LP'ship has other quirks.

A. The investor wants single conduit but he also wants to resemble a corporation as much as possible, and he wants as much liquidity as possible. Some forms of the P'ship created a battle with the IRS. These forms are:

1. Create a GP'ship that was a corporation in which there were no assets.

This way they were essentially judgment proof.

Uncle Sam said NO. Must have assets equal to 15% of the equity raised up to the first million and some scaled down % after that. This was called the SAFE HARBOR RULE the GP must be able to demonstrate that he has real assets to be able to meet real liabilities.

2. Relative liability of the GP & LP's
Equally liable (by inference, equally not liable)
(E.G.: FHA insured, non recourse mortgage - neither GP or LP are liable and is therefore suitable).
3. The third problem has to do with liquidity. What if a LP wants out? Some alternatives:
 - a) Internal solution - set up an escrow acct. to buy out the LP
 - b) sell shares on the secondary market at a discount
4. The law of LP'ship has been evolving quickly. Great deal of litigation occurring mostly from conflict of interest Developers and property mgr's having overlapping multiple interests. For example: A developer who also owns the prop. mgmt. co., and steals a tenant from one of his buildings to fill another; or, a developer building 2 or more bldg's of the same type in the same vicinity, effectively over-building the market.
5. The laws have boiled out that after the GP has stated his other activities, and if the LP's are dumb enough to go along with him, they lose. Unless there is a blatant fiduciary violation.

The Limited Partnership (cont'd.)

The limited partnership of the early 80's was a somewhat different critter than the one that we see today. Many of the problems of being a syndicator, and structuring a limited partnership remain, although the facets may have shifted to a different syllable because the tax laws are no longer what they once were.

The first issue for a limited partnership is whether it is going to be a specified or unspecified property fund. Unspecified property funds are often referred to as blind pools. It is attempting to address the reality that we were referring to the other day that there is a long time period between the time at which you might tie up or control a property and you finally got through the whole legal process of being able to issue publicly shares in the partnership. The idea of the blind pool is to raise the money first, with an investment specification or strategy maybe, and then be able to bargain more effectively, as you can go for a quick closing on available properties, you have the cash, get a better going in price. The fund can raise more money with the same effort. For example, it is not that much more difficult to raise twenty million dollars up front than it is to raise five million dollars. You are better off raising additional money in one fell swoop, and then look for opportunities to buy for cash, getting better selection, better pricing -- a portfolio effect if you will, rather than funding one property at a time with individual syndications.

The problem is that many people are suspect of the blind pool, as they are not quite sure if they want to buy a pig in a poke. Many states, such as Wisconsin, probably would not permit you to register a blind pool, simply feeling that it is a license to steal and that in the absence of any evidence to the contrary, the organizer/general partner will simply buy whatever there is to buy in order to earn the fees, and there is no ability by the investor to analyze and be aware of what it is that he is purchasing before the fact. Some states permit the blind pool, other states make it much more of a hassle with rather strict specifications as to what kinds of property can be acquired, and other states like Wisconsin will kill it altogether if they can.

Due diligence, while not performed before receiving the money, is still required by the general partner as a fiduciary, but he does not have to go through the processing with a series of folks in advance.

The second element is whether it is an open or a closed end fund, whether the acquisition or pool is a one-shot deal, or whether they could sell a property and buy another property and continue forward in the future, do they have to distribute the proceeds to the investor when they sell the property. The open end funds allows them to trade, move in and out of various properties, and continue down the path until they have reached the stated termination date for the limited partnership.

The third area of concern is sponsor compensation. There are an infinite

variety of ways for sponsors to compensate themselves, but they break themselves down into three (or four) major sections. The first is the fees on ~~acquisition and marketing~~. The second is the property ~~management~~, with two aspects. The first aspect is managing the property itself, and the second is managing the partnership, which is a separate function and for which he can also be compensated. The accounting, the filing of reports, keeping the investors informed, etc., are functions of managing the partnership and not the property. This separate fee could include rent on an office building, secretarial services, accounting and legal services, plus some nominal fee for the time involved of the general partner. The third area is the ~~back end~~ load as it is called. What does he get at the time that the partnership is terminated and the various commitments have been met? There are obviously several levels of participation.

One is simply the fee for finding a buyer and disposing of the property, and typically the general partner has an exclusive brokerage commission in which the commission fee is stated as part of the partnership agreement. Second, there could be an incentive fee in which if he meets certain goals with regard to minimum rates of return, prices in excess of certain floor, etc., he would get an extra kicker. Third, there may be a flip-flop clause that after distributions have reached a certain amount the residual would go entirely to him or at least 50-50 to him, sometimes more.

The degree of sponsor competition, and when he receives it, is such that the sponsor would like to get as much up front as possible, but quite often that is not possible to make the numbers work. This up-front amount is often referred to as the "hog factor". The National Security Dealers Association typically puts a limit at 18% of the capital raised as being the maximum that the dealer can take out on the front end. That 18% would cover sales commissions on the sale of the partnership units, finders fees, advising fees, all of the other fees that he can dream up. Management fees relative to the operation of the property, probably about 5%, must be close to the norm that a third-party professional property management firm would charge. Most general partners would try to come in below the typical market rate to avoid controversy.

The back end load is where they kill you. The back end load of course first involves his normal participation, e.g. if he is a 5% partner he gets 5%. It is very important to know how the 5% is defined. If he is careful, he will define his 5% on a very high number (e.g., net sales proceeds less first mortgage balance). After taking out other expenses and a stated rate of return for the limiteds, he might then get 40% of any of the remaining profits. Quite often he reserves the right to participate in any new partnerships that are formed after the sale, and can start the process all over again. He can control where the property is sold as long as it goes for a fair market price and he hasn't chintzed on the existing partnership. That ability to control the resale gets a lot of general partners in trouble, because if the limiteds feel that they did not get top dollar, they sue, charging a conspiracy. Because general partners can own up to 20% of the old partnership as a limited partner, they can move from that position to a general position in a new partnership without being guilty of churning.

If they go from general to general, Uncle Sam may accuse them of churning.

There is nothing to prevent the general partner from diverting the insurance premium to his insurance agency, the property management fee to his management company, repairs, etc. The idea of controlling the enterprise as the general partner is to create as many profit centers as possible. Certainly, many developers over the long run have discovered that the real profits have proven to be these various fees. Once you get up to a point where you have 2500 to 3000 apartments to manage, the cash flow from the fees becomes substantial, and can be used for a variety of purposes. Leasing commissions on commercial properties can average 7% of gross, in addition to management fees. Much bucks involved even if the real estate goes nowhere, and only the investors go down the pipe. The National Securities Dealers Association does provide some benchmarks as to maximums (more on this next week). Depending on how clever the general is in setting up the financing, most of the front end money from the limiteds may not have to go into the project at all. The NSDA has tried to constrain this. The amount that is taken out by the general contractor escapes the NSDA limitations. It is therefore not a surprise that many syndications have been done by those who could build the deal as well, creating a significant profit margin for their general contracting arm that had nothing to do with the syndication profits. (Much soft money can be drained out of the project.)

The prospectus must define reasonably well the investment objectives. These are also tied to what is perceived to be the target investor for the syndication unit. The security rules are fairly specific as to the difference between a qualified investor and an investor. A qualified has a certain net worth, has a presumption of a certain education level and a familiarity with business practices. The net worth does not include the house, car, personal property, etc., and if that is the group that one is trying to reach, one might want to set up a minimum unit of \$100,000, \$200,000, up to one million a shot. If that is your target market, that makes for a different type of investment objective as to what that type of investor would be willing to look at as opposed to the guy with only \$5,000.

The ~~investment~~ objectives can relate to a number of different things. The partnership can create value by developing a piece of land, taking a relatively long term view. It can purchase and enhance the cash flow of a property that needs renovation and repositioning. It might want to exploit government programs such as Section 8 or FHA, whatever. It might be to create capital gains at the expense of current dividends. It might be to provide maximum tax shelter, and once the maximum shelter had been obtained, the property would be traded into a REIT, etc., and the investor would move forward through a successive series of rollups in the investment. For example, merging one or more limited partnerships that had exhausted depreciation and interest write-offs being combined with an entity with large carry-forward losses to provide additional shelter. This type of maneuver ought to be at least broadly sketched out in the prospectus so that the investor has some idea of what will happen in the future. The general partner will of course try to keep things as vague as possible so that if things don't go as planned he will have an out.

A number of other issues that the limited partnership tries to deal with include the ~~role of disproportionate allocation~~. At a time when tax shelter was a significant portion of the real estate investment game it was often desirable that some people receive tax shelter, while other people receive cash flow. Some people would receive a faster payback on their capital than others, depending on the nature of their investment. To accomplish this, quite often two classes of partnership shares are created. One of the legitimate economic reasons for disproportionate allocation might be payback. If share A put in \$8.00 per unit, and share B put in \$2.00 per unit, share A would get all of the shelter until the tax savings equalled \$6.00 per unit. At that point each has the net at risk of \$2.00 per share, and now you would go forward and share proportionally. Other ways to do it would be to split the investment between land and building, with the land in one partnership, the trust conduit would own the building, and then when you got down to the point where they were relatively equal merge the interests again. There was in the past a considerable effort made to give the investor the type of compensation that he desired. This, of course, is not as important as it once was since the changes in the tax laws.

A second element of investment strategy would be to define for the investor what ~~stage of the life cycle~~ the fund was expecting to participate in. Were they going to buy land and build new, or were they going to buy existing property and renovate, were they going to buy existing properties with no need for repair that could continue forward to produce income. And they generally provided some type of timetable as to the exit from the investment. When to get in, when to get out. what are the implications with regard to the duration of the investment. Where are we on the time cycle?

The next elements are some constraints and parameters with regard to ~~leverage~~. How much debt will the partnership be allowed to carry? This is cause for mixed emotions. To some extent the investor would like, to the extent that he foresees inflation, to carry a relatively high ratio of debt, but by the same token he does not want any personal accountability. Therefore, an FHA insured project allows a high ratio of debt since they would go to 90-92% of value, at the same time if it is a Section 8 deal he is guaranteed the cash flows even with the high leverage. Quite often, and for quite some time, syndications were priced as a per cent of the mortgage, because the mortgage seemed to be a good proxy for the value of the depreciable asset. If you had a 90% loan on an FHA project, you could sell that for 30-35% of the amount of the loan. That meant a lot of cash up front for the syndicator, in addition to his other fees. This is no longer as lucrative a situation. The more the price of the deal was hiked by funny money financing, the more depreciable assets you got, the more you could sell the partnership for, and it was a neat little money machine.

The qualified or accredited investor, who was the primary target that all of the syndicators were pursuing, had to have the following kinds of characteristics. An individual had to have a net worth of at least one million, an income of at least \$200,000 in the past two years with a future expectation that it will continue, and it also included entities,

that were owned by such individuals, they could set up a corporate holding company if they wanted to, and included tax exempt organizations with assets greater than five million, i.e., pension plans, endowments, etc., and individuals who would invest a minimum of \$150,000 in that particular project within five years so long as the commitment was not more than 20% of their net worth. The premise was, of course, that these wealthy investors had access to legal and accounting advice, had business experience of their own, and therefore were operating knowledgeably, and therefore did not have to be protected by federal and state blue sky laws. This was a fairly major premise considering the kind of crap that they bought.

The type of partnership that would appeal to that type of group was typically involving a small number of investors, such as five of them each going in for \$200,000 over a period of three years, which would, with leverage, allow you to have a five million dollar piece of real estate with only five limited partners and a general partner who put in nothing but his expertise. You didn't advertise the units, the cost of issuance was small, and as further protection from the SEC, if all of the investors knew each other then you could be exempt from misrepresentation. This is not too different from the new accounting rules that say that an accountant can provide a forecast based on empirical data if he he not going to be there to explain it, but on the other hand you can use a projection based on any what-if that you want as long as you are going to be there to explain it individually. The premise was that with a small group of investors there was nothing floating around with the public at all.

Because many of these so-called wealthy investors were looking at the real estate from a tax shelter standpoint, the result was that the general partner/sponsor was able to do things that made no sense at all as long as it made a tax deduction for the limited partners in the early years of the project. Hence, they became very creative in inventing a variety of fees which were presumably for services, and they could in fact deduct them in the year in which the syndication was formed as a cost of doing business, and therefore accelerate the write-offs in the early years. Starting with about 1979, Uncle Sam started to spike those types of things, but each time the tax law identified more of these, more creative ways were found to get around the limitations. Private tax law attorneys are paid much more money than are government lawyers. Many of the best government lawyers are often hired away by private firms who want their expertise.

The limited partnership creates a number of problems for the general partner, and for the limiteds as well. It is really not what you sell, but how you sell it, that ultimately represented the major risk to the general partner. He could protect himself reasonably well against liability for the partnership, although not entirely so. Incidentally, it was popular during that time to give a young, driving project manager a piece of the deal, as opposed to a bonus or salary. This would leave him with nothing in case of problems, as well as liability. In the case of bankruptcy, if a bank chose not to foreclose, the forgiveness of debt was construed as a form of income, upon which you would have to pay income taxes. Take your compensation up front!

There are several remedies for the limited investor against the general partner. First, anyone who offers or sells securities in violation of the registration rules or prospectus requirements has absolute liability to any purchaser who may have bought it, plus damages, plus interest on the money. Section 12, Part 2 of the securities laws gives the right of rescission to the investor and damages against any of those who offer or sell by a prospectus or by oral communication which has materially untrue statements. Section 11 under the securities laws gives damages to those whose registration statements contain untrue statements or omissions. Those who are liable for the prospectus include the sponsor, all who sign the registration statement, including the appraiser, the accountant, any directors, any general partners, any advisors, any underwriters, who can only escape if they indicate that they did in fact provide due diligence. This is why law firms hire our graduates to research the real estate aspects of the project, because as the law firm advising the general partner, they are equally liable with the accountant, the appraiser, etc. That is why as an appraiser you have a hold harmless clause that states that the appraisal cannot be used in conjunction with a prospectus without the permission of the appraiser, and without the appraiser approving exact language in which the results will be reported. These various professionals are very unhappy about this situation. The idea is that none of them will be inclined to be part of a conspiracy if they might have to take the consequences.

Section 15 imposes contingent liability on those who control the persons who are liable under Sections 11 and 12. "I knew it was illegal but my boss made me do it." Good, you are both liable. Section 17-A prohibits fraud and gives a private remedy to the purchaser and applies to all partnerships whether they are exempt or not. (Fraud implies intent, which is not always easy to prove.). Finally, Rule 10-B implies that a private right of action for sins of omission and commission are quite permissible. If you fail to disclose something that you should have disclosed, then the limited partner who is now disgruntled because the investment is now worth less than he expected chooses to sue on that basis, fine. Therefore, in the prospectus, you always put in more information than you think is necessary, even if that is likely to kill the deal, or make it difficult to market. This would include any past legal actions against the general partner, and even any personal problem

that he has had which might give a limited partner a clue toward his true character. Many have chosen not to become general partners as a result.

Much of Sections 11 and 12 are based on discovery rather than when the sin occurred, so if you don't find out until 8 years later what in fact transpired, you still have an additional three years beyond that to bring suit. Given the poor economics of many projects, the investor can elect prima facie that he was defrauded, and the courts have been very receptive to that with the exception that any tax benefits that the investor received despite the fact that he never got any money back as the result of the investment would be a credit against the damages. So, just the fact that it didn't work the way it was supposed to have worked may be grounds for fraud. The SEC can place an injunction as well as criminal penalties for specific violations, and the burden of proof is on the plaintiff initially, but the defendant has the burden of defending any exemptions from registration or use of statutory defenses.

on (unintelligible).

Syndicators can pursue two relevant exemptions. First, the private offering exemption under Section 4, and the intrastate exemption, which is called Regulation D. The other major exemption initially included issuers such as banks, placements to pension funds and other similar institutions, or business promotions by the founders, where there was an identity of interest between those selling the security and the management of the company. In that case they did not have to be securities dealers as long as that individual was not hired primarily to market the security.

In March of 1982, the Real Estate Board lobbied very hard and successfully to create a three-tiered structure of exemptions, and bring a lot of real estate out from under the SEC. Interestingly enough, the SEC at this time was run by Bill Casey, the later head of the CIA, and one of Reagan's long-time advisors and confidants. Casey wanted to bring real estate in all of its aspects under the securities laws, and the R. E. Board was able to successfully fight back, and to carve out some big exemptions, as we shall see in a moment, to keep R. E. in the hands of the brokers, rather than requiring a securities license for sale, as most real estate brokers weren't bright enough to pass the securities licensing exams. Furthermore, one couldn't be both a R. E. broker and a securities person, because the N. A. S. D. wouldn't permit it. You had to set up a separate entity for each.

The three tiers are essentially labeled rule 501 through 506 (he seems to mix and match these numbers, and it would be advisable to look at the actual regulations for an accurate accounting of the numbers.) the first one that you need to be aware of is Rule 503, which involves offerings of equity up to \$500,000. The second limitation is offerings up to 5 million dollars in equity to a limited number of accredited investors, as defined earlier, which is Rule 505. The third level is offerings to an unlimited amount of securities to a limited number of suitable persons. A suitable person would be a pension fund, a bank, and similar types of investment organizations, who presumably are knowledgeable in the selection of their investments. In each of these cases, you could sell up to a maximum of 35 non-accredited investors, but you could sell to an unlimited number of accredited investors or suitable investors.

The small investment, less than \$500,000, does not have to register with the SEC, but probably does have to register with the state. Regulation D investments are probably the primary hole in the SEC act, which simply exempted the small investment from further concern, as well as providing for this new type of investor called the accredited investor. The six rules, 501, 502 and 503, (see what I mean?) simply contain definitions and requirements that are applicable to the balance of the rules, 504, 505, and 506. The real gist of the readings would be to look at the last three rules, 504, 505, and 506.

For the small sales not exceeding \$500,000 total equity, you simply have to disclose that you are going to organize and submit your investment plan and demonstrate to the SEC that the entire offering is made within and in compliance with the state for that particular investment. It is only the state that need be aware of the project. In Wisconsin, anyone

who is a syndicator would have to file a plan no matter how small the investment, but you are allowed one deal before you are defined as a syndicator. So, if you do a small deal, and get four or five of your friends into it as a limited partnership, you are allowed one free bite. After that, anything that you do using a securities format would have to be filed with the state and obviously with the SEC if you have to. The great majority of local broker deals fall under this exemption. The marketing of any one of these is extremely constrained as far as what you can advertise, what kinds of information you can present to the investor, and how you qualify yourself to do that. At one point, a great many of the national syndicators would hold schools, and they would nominally teach you real estate investment. There was one group called Keystone that was particularly sly. When the computers first came out, they would analyze your investment portfolio from the standpoint of how much real estate that you could hold. All that you had to do was fill in a questionnaire in which you identified your net worth, assets, real estate holdings, etc., and they punched this into the machine and would come back to you and say you need so many dollars in each of a number of investments. The catch was that they would now have a picture of your holdings, which would make you a target for their sales force, who would show up soon after to sell you shares in their projects. Many of these were run by professors, or people that presumably had some knowledge about real estate, and so they tried to take the credibility of the speaker regarding his subject and impute that to the quality of the real estate being offered for sale. Finally, in a court case, they ruled that all forms of marketing in that form were illegal, and attempted to misrepresent the credibility of the source. The presentation of the prospectus with cash flow format has gone back and forth. Until very recently, a syndicator was not allowed to present a cash flow statement about the property, other than past years for which there was a known history. He could not promise great things. Casey changed all of that, saying that R. E. is a futures investment, and that a forecast was needed in terms of increased expenses, income, resale price, etc. California tried to provide very tight constraints on how you could make projections, with maximum rates of increase in rents, expenses, etc. Most other states and the SEC have not gone along with the prospectus rules adopted in California, and thus you will see a wide variety of types. There are now a series of court cases that indicate that a real estate broker or syndicator is liable where the property falls gravely short of the projections that were represented. The debate continues on this subject.

April 6, 1988

Corporate structure for Real Estate

Advantages (Overview):

1. Limited liability
2. Ability to tier voting control
3. Structure preferential returns
in terms of 2 classes of stock or 3 classes of stock or can have preferred dividends or voting stock and nonvoting stock

Major advantages, in a little more detail:

1. Limited liability
2. Gives clear dichotomy between individual investor and the real estate, so literally can keep 2 sets of books. Can have fiscal year that is in sync with your own personal fiscal year, which allows you to move income into one year or another (can't do with Sub-S or LP) Often quite useful -- can declare bonuses month after their taxes filed which allows them to defer payment, or you can play a variety of other games to mitigate your taxable income.
3. Small corporations (sales less than \$1,000,000) are allowed to use cash accounting basis and cash acctng also very useful device in that you don't have to book receivables until they're collected (you may not even bill your receivables until the fiscal year is completed if it will move you out of an advantageous position). So there is some ability to better time the impact of your taxable income in the corporate framework than there would be otherwise.
4. Ability to share ownership with executives or staff on a limited basis -- can provide either (1) stock options to encourage their longevity of employment or (2) provide the right to buy stock in the company with a specific buy-back provision if they leave the company so the appreciation in net worth the co. during the time can go to the employee. Certainly not the only way to do so -- providing psychic benefit to the employee -- by providing (1) ownership position and (2) feeling they have something to say about the operation of the co. Generally the agreement of our graduates that equity ownership position is not all it's cracked up to be and if had option in future they would rather have cash bonus now in which could put in something safe like US Treasuries. There certainly is something to be said about not having your name on the note. Corporate stock allows to share the upside without any personal liability, which you would get as owner via a share of the general partner interest in the partnership format.
5. Not required to classify income as passive or portfolio or personal and, thus, able to use earnings from RE to shelter other income. So if running a little appraisal company, your're better to run the company as a corp. and shelter the income you don't pay out with your ownership of a couple of rental properties with appreciation that's still available under the tax law -- can mix and match under the corp. framework that not allowed to do as an individual.
6. Can take 25% of taxable income and put it in various forms of profit sharing -- that profit-sharing program itself is not

taxable. Ex. Owners of corp. name themselves as trustees of the profit-sharing trust and then can invest that money as they see appropriate. with long-term liquidation at preferred tax rates when retire -- kind of like having own private IRA or Keough that you can then utilize to, say, buy a ground lease that has no tax shelter to it but provides favorable income that would not be taxable Put site in pension fund profit sharing account and run your ground rent into that which is not taxable and keep the appreciation of the building in the corp. and gives degree of flexibility that can't do with single conduit structure. Corp.s, therefore, provide great deal of shelter income, but not necessarily in the traditional format.

7. Ease with which can be subdivided within the estate, particularly where have multiple classes of stock and the partner that survives gets the controlling interest even though may not want to give the entire interest it may make the ability to buy out your voting shares more feasible. given the life insurance is available to back up a cross-purchase agreement and at the same time leave the future value of the assets to your heirs that don't necessarily have voting privileges with their class b shares or can go the other way and use the preferred shares to freeze the value on generation 1 and allow to skip to generation 2 (nonvoting).

Great deal of flexibility in terms of how its divided up, either as part of the estate plan or compensation for other associates in the venture or etc....

Also can alter the timing either in terms of the fiscal year or the timing of the profit-sharing for management that may postpone tax till 30 years downstream.

Cash acctg also allows you to fine tune tax advantages.

This all explains why the IRS continues to tinker with the tax law -- if there seems to be some weird regulation in the laws you can bet that it is meant to cover a loophole that existed prior to the revision.

8. More flexibility in terms of exit from the RE.

a. Trade stock with REIT or other stock entity -- move up from local entity to entity with natl standing or listing status or maybe trade on one of the over the counter exchanges -- a share for share stock exchange is certainly cleaner and simpler than trying to find a match for each property in your portfolio.

b. Single tax liquidation has been somewhat curtailed by the '86 tax law -- at one point one of THE big loopholes in the tax law -- if sold all assets within 30 days or 12 months avoided all capital gains tax at the corp level. In 30 day case could have buyer in hand before the Board of D made thier decision and in 12 month case the Board had to make a policy decision they would liquidate and then could go out and seek the ultimate buyer of the assets. As said has been sharply curtailed but still possibility of doing so. The distribution doesn't have to be entirely in cash -- can roll-up assets into the corp. as nontaxable event and can also distribute assets of corp. on prorata basis to shareholders as a nontax event...EX. Corp. did sub-division and su-div. now substantially complete in lang. of the IRS and you still have 12 lots to sell and have 3 shareholders could spin off 4 lots apiece and they wouldn't have to pay tax until sold their lots. Basis would be whatever they

paid for the shares in the first place. EX. If your doing a 40 acre plat, zoned for multi-family or commercial, may break into 3 pieces and spin off to shareholders and allow them to groundlease to someone that actually built the buildings (maybe your own corp.) and groundlease income move thru the corp. as an expense to SHs that now own the land and then have no taxable event except for income received anyways till sold the groundlease (capital gains at that time) Great deal of flexibility in terms of how move assets and income in and out, and the timing of the income -- therefore corp. form can be very attractive medium for RE investment (contrary to popular mythology that single-tax conduit always better). Currently the little guy (less than 100,000) has some advantage in that can take 25,000 of tax shelter so that if at that lower level single conduit may be more attractive but if filing joint return people can be moving into 60000 area pretty quickly and it wouldn't take much of a piece of RE to put them near the 100000 mark so little guy has to be very little indeed to take advantage of the 25% shelter.

Additional advantages:

1. Raise successive capital more cleanly LPs have difficult time expanding unless allowed for that upfront. Can sell additional stock with minimal effort and even if have to register a stock prospectus it is easier to do so than a new fancy LPs etc..
2. Easier to raise Large amounts of additional capital.

Once get into really large corp. now have whole new realm of capital sources -- bonds, commercial paper, qualify for venture capital loans in which provide stock option to source of the venture capital.

By + large corps have the greater flexibility to grow (raise K) with least amount of reorganization. Probably the one thing that does modify as raise more K or decide to go public or semi-public is the accounting. Become more concerned with accurate accounting etc.. so that again the flexibility of deciding when to take profits and when to record them becomes way of est. 3-4 yrs before the actual issuance of a new stock issue a track record of gradually increasing earnings etc.. so that the investor will look at this as a growth opportunity. As corp. moves out of cash acctg little business phase gives all kinds of opportunities to bamboozle on the basis of your past record and perhaps confuse the investor by his tendency to look at stock measures (P/E ratios) vs. the underlying assets. This was something Carley did so beautifully -- starting with Public Facilities Associates.

So much for that -- have reading on that as well.

Oh no, it's that darn Chris Quinn asking another question and making my typeup longer. This better be an intelligent question Quinn or else....

Chris: Chief, a REIT is a single tax conduit right?

Chief: But it is also a corporation.

Chris: Well, it can also be a trust or a-

Chief: Yes, the old ones were Massachusetts Investment Trust but today the majority of them today are going to a straight corporate entity.

Chris: So they are double taxed?

Chief: No! The REIT remember is a critter of the IRS law not of the corporate law. You can be a corp. and be a REIT or a Mass. Trust and be a REIT or be a partnership and be a REIT.

Chris: (Some guys never give up) But the corp. is double taxed and the REIT is single taxed I don't understand ...

Chief: Because the IRS says that if the REIT follows certain rules, 95% of their taxable income is distributed, they have at least 100 shareholders, don't have more than 50% of the control in less than 6 individuals, etc... if you meet all of those then you will be treated as a REIT by the IRS. Now have 3 months to correct errors from those guidelines. Like the REMIC, the REIT is a creature of the tax laws.

Chris: A REIT could be a way for a real estate corporation in real estate to avoid double taxation?

Chief: Yes. REITs have got themselves into deep trouble, didn't know what to do with their tax shelter and didn't have anything to pay out and so forth. Went back to being a corp. and as a result all of the losses they had been taking markable as tax loss carry-forwards, which they couldn't have done as a REIT. Now after 5 years of they got back on their feet and now could decide whether wanted to go forward as RE holding company or become a REIT again, which they did by applying the then rules of REIT status. Not allowed to flip more than once every 5 years.

(Well, I think Chris has been satisfied, so we can move right along with the lectu- - OH NO, not another "friend" asking a question).

Charles: I haven't been keeping up with the tax laws but I remember (probably an acid flashback) it used to be that when the tax rates were different there were a lot of penalty taxes on corps that didn't distribute their dividends/income in that the game was to keep the \$ in the corp. and try to reinvest it and get taxed at the lower rate. All those laws are still in effect even with the changed tax rates?

Chief: Yes, much of the rate differential has been lost. In the past the corps would do a whole bunch of wild assed things to justify their retention of earnings. So yes that was always haunting them. The other thing that was haunting was to be labeled a family holding company (which is confiscatory). So important to maintain what appears to be an operating company. Therefore certain types of buildings became popular (hotel, restaurant,) by def. operating businesses that happened to use RE. So if generate large gross from an operating business avoided the holding co. classification. Eventually the IRS caught on and changed the rules.

Now have looked at some of the idiosyncracies of structuring, etc... In this course trying to sensitize you to the broad array of issues and why need accountants and lawyers to help with tax aspects as create entity for RE venture.

Shift ground for balance of semester to more investment strategy and away from the more technical aspects of the tax laws, structuring, etc....

RE investments come in 2 sizes

1. Individual property or
2. Portfolio (2 or more properties)

Literature has predominantly been on the port. side currently. for several basic and perhaps obvious reasons.

1. Big \$ in RE invst from group investors who are inter for FFs or invstmnt groups or for dissatisfied Am. stockholders. Amount of \$ is such that many times it takes more than 1 property to use all the \$ available so that automatically in port. status.

2. Shifting perception of the fiduciary

ERISA in effect, upgraded the prudent man rule to the professional prudent man rule. Anyone exercising discretion in the selection of a pension investment, is personally accountable for negligence in that selection process, not ot mention for deceit, negligence, and being an all-around bad guy. The crime is always with you and there are obviously retributions for that. The real issue is: What represents negligence? and growing out of that are a # of aspectes have already run into.

1. ERISA placed greater emphasis on diversification to disperse risk, but never defined diversification. This is 1 of the most heated subjects in RE right now. Once assumption was that if bought 1 of each, had a retail center an apartment building and an industrial place, that was diversification. But if bought all 3 in Houston, no way. Not going to come up with a hard and fast answer but getting good bead on where going.

2. What is due diligence?

a. What should we buy strategically?

b. What can we close on tactically?

How careful do we have to be? Which surprises couldn't have been anticipated and which could have been known if they had been thought about? Ex. How do you view a thermal scan on the roof of a ind building to see if it has bubbles that suggest it will deteriorate in a relatively short period of time? It only costs about 10 cents/sq. ft.. But if don't do it and have to replace at 3.00/sq. ft. are they liable? Soon will find out if courts feel so because Northwestern Mutual is suing the hell out of somebody because they have that problem.

3. What represents performance?

How know the trustees, having avoided the pitfalls of 1 and 2 above and having operated for 5 years to establish a track record, maxed out on the property? Could they have done better? Could they have had a better return if, for ex., they had pursued tenants better in terms of rent collection? Is performance positioning yourself for maximum return or protecting yourself from unexpected inflation? Can you measure the performance of a manager on the basis of current earnings if his/her major function is to protect against unexpected inflation?

Stocks and bond measurements are wonderfully precise and incredibly precise -- remember the Crash. Basic defense is that if in with the group then you are no worse than the next guy -- better to stand separately than to hang together. RE doesn't lend itself to that type of psedo-precision. Must have a range (unless you're a traditional appraiser who can value accurately to the penny). So have problem of trying to measure performance in an industyr that has terrible time doing so, but know have to do better than in the past.

Need to look at all of those elements as begin to build a portfolio investment theory or strategy.

1. What type of property and where?

2. Ensuring the decision maker (whose usually remote) in an industry where data is scarce, where inefficiency exists and therefore the advantage goes to those with data, how much \$ can I spend on diligence in implementing my what and where policy? Hopefully there will also be correlation between downside risk and the amount of \$ spent up front on research. To the degree that the institutional invstr wants to avoid liability how much can shift by assigning discretion in the what, where, and information search and how much retain control of the the decisions? Good deal of conversation between the discretionary asset manager and the nondiscretionary asset manager. Where does the liability fall for a mistake? What kind of protection can you count on?

Have real problem in industry right now, coming to grips with this management problem and structuring some kind of balanced relationship between them that have the \$ to invest (institutions) and them that provide the services to invest the \$ in such a way that they can solve these 3 related issues: (1) the what and where, (2) due diligence, and (3) performance. We'll pick up on those on Monday.

Real estate 850
April 4, 1988
transcribed
by
Evan D. Harrison

Mr. Eppli would like to say a few words.

Eppli: Case study #3:

All month-month leases that are in your case as m-m, assume a lease start date of 1-1-'87. No costs, no free rent, also no concessions. That is only true of m-m leases. No leasing commissions or tenant improvement costs. All leases expiring prior to 1-1-87, assume they re-rent, no costs also. A good example is the second lease, you see it on the second page, you see it expires 8-31-'85, assume it rolls over onto 9-1-'85 for a three year term. Acc. 201 has an assignment due one day after this case is due, so things are going to get really busy next week, so start early.

We want to touch on three subjects today. Finish up on trusts, talk about master limited partnerships, and get started with REMICS.

A good example of a trust with some of the fancy accounting that they do now, nevertheless with the openness that the new trusts have, is one called EQK, which is essential Equitable and Krafsko. the properties came out of Equitable's portfolio and the property management group is Krafsko. It has only three properties in it. It is a finite trust. And because shopping centers and office parks don't cash flow well enough to attract investors, a large part of this was financed with a 44 million zero coupon bond back to Equitable, the original seller. A lot of these trusts, as well as REMICS, will be a result of major institutional lenders adjusting their portfolio and retailing properties which were at one time only institutional properties and allowing them to reposition into what they perceive as stronger properties or growth markets. This particular property the trust was capitalized with 45 million of zero coupon notes which will have a face value of 94.7 million at maturity in 1992, and an effective interest cost of 10.9%. Obviously a very strong manipulation of the cash flow to attract investors. There are only three properties in it. The first is a commercial office park of 1.2 million sq. ft. in Indianapolis. It was appraised at 77.5 million. If you work that out, that's a fairly modest cost per sq. ft. of leasable area. It represents about 37% of the total value of the trust, but had a 9.8% vacancy going into this year. The second is a high class office building called the Peachtree Dunwoody Pavillion in Atlanta. 673,000 sq. ft. appraised at 76 million with a vacancy of 9.9%. Finally the jewel of the package. That's the way most of these are put together. There is one tomato you would love to have and a couple that are marginal all in the same colophane. Like sentries you have to take the 2 marginal ones along with the Roman beauty. This is Harrisburg East Mall, 898,000 leasable, appraised at 52.4 million, with a 1% vacancy. The reviewer looks at each of the three properties and their obviously different markets. Indianapolis is a slow steady growth market, Atlanta has been explosive, but inclined to overbuilding - spinning off into the NW 1

corner, where this property is located, so it's in the right place. Harrisburg Pa. is going nowhere with the W. half of Pa. Not a growth area, which is why they decided to get out of it.

Now they look also at the lease mix. The comm. park is almost all short term leases, so several thousand sq. ft. are rolling every year. They expect 73% of the tenants to renew, & for the balance they are neg. on 80,000 sq. ft, which leaves only 98,000 sq. ft. exposed to the market. At the Dunwoody Complex, things are messier. Tremendous free rent and standard tenant concessions down there. It has an occupancy now of 89.6%, so they are losing ground. What's worse, their key tenant, DEC, will be moving out in 20 months. The shopping mall is just humming along. The variety store is being converted to a food court, and they have 100,000 sq. ft, rolling to market rate in 1989 and 1990.

They are making about \$1.66 dividend, of which 1.00 was from earnings and .16 was from extinguishing a part of the shopping center debt. That puts the yield at 13.8%, which is attractive except for the 0 coupon debt. You have to anticipate that your equity is going to go down when the 0 coupon explodes on you in 1992 which isn't all that far away. If you start reserving for that, your yield drops to earnings of \$1.04 and an 8.5% yield. There is virtually no dividend growth expected before the 1990's for the reasons mentioned earlier. The shares are selling at a 26% discount to the value of the underlying assets - at \$16.5 per share. In other words they are looking at the underlying values, which in the old days got sort of submerged and forgotten. So if you want to take the gamble that runaway inflation will bail out the investment causing the shopping center to perform well and cutting off new construction for indianapolis and Atlanta, it is an interesting speculation. As of Jan. 1 of '87, the price was at 12. Notice there are only three properties in this one. Zero coupon debt is the favorite form of structuring in this type of deal. The yield on this was 8.39% for '87. Not too impressive.

the ones who are doing well are Krafco, who have the property management, and Equitable the asset manager, which gets probably 150 basis points for setting this up - that's 3 million up front. They probably get 75 - 90 basis points for running it, and a 100 basis point kicker on the back end. Because these are figured on the total asset and not the equity, they are doing very handsomely also. Since shareholder's equity is only 101 million on a 171 million capital base, the fees are leveraged almost 2/1, so the fees are almost more than the return to the investors. This is really why the insurance Co. will go into these kinds of deals.

One critter that appeared initially in the oil industry, then in R. E., is the **Master Limited Partnership**. The MLP differs from the corporation in several ways. Of course, in the corp. form, liability is limited to your net assets. MLP's are organized around two types of partners: limited partners, who have no more liability than they would in a corporate share, and general partners who are individually liable for the debts and possible claims, i.e. damage claims against the MLP. Corps. have an indefinite life, and MLP's have a finite life. In addition, the nomenclature is a little different. In a corp., the investor owns shares and receives dividends. In a MLP,

the investor holds a partnership share and receives distributions. It is a single tax conduit, and therefore those distributions may include, actual taxable income, capital gains, and simple distributions of capital. Unlike other limited partnerships, MLPs are traded securities, and can be bought and sold on the securities market.

To compare the corporation to the MLP is probably more instructive than to compare it with a standard limited partnership. At the entity level, there is a tax on corps. at corp. rates, while the MLP has no tax. At the investor level, anything coming from the corp. is taxed as income unless it is called a partial liquidation, which is frowned on by the IRS. With the MLP, the distributions are not taxable, unless the investors tax base has been reduced to zero. The income may qualify as passive income. One of the major problems with the MLP is the expense of the accounting. If you are not into accounting, you won't like MLP's and you won't like the annual report that you get and have to transfer to your report. Gains on unit sales are taxable for the MLP as ordinary income, where with the corp., after 6 mos., the gain on a share of stock is taxable as capital gain. The investor tax basis in the corp. is what you paid originally, minus any unlikely partial liquidation distribution. For the MLP, you start with the original purchase price, then you add back the taxable income he has received, the non-recourse debt, then he subtracts actual cash distribution, the tax losses he took on his form, and his debt repayments. Again, an accounting nightmare.

Now the IRS hates LPs, and especially they hate MLPs, and they got a law which says the MLP will be taxed as a corporation **except** where 90% or more of the income is received from real estate or from extraction. Obviously the IRS got beat hands down by the real estate lobby and the oil lobby. While you will probably hear that the MLP is a dead dodo, you probably won't hear that if 90% or more is in real estate, everything goes on as before. A classic case of Wash. D. C., where those who want reform get reform, and those who want an exemption get an exemption by paying off the right committee members, so everybody's happy - except a few of us, who would like to see them put the whole thing to bed. In the oil industry where you had a number of individual partnership wells, it was helpful to market the oil effectively, to roll those up into a single revenue base, and also tended to stabilize the revenue where each well had quotas established, etc.

There are basically three reasons why the MLP is popular in corporate finance. One, it converts a double tax entity to an operating corporation which is a single tax conduit. It eliminates the corporate tax, and therefore increases shareholder values with the cash flows which would have gone to pay income tax. It comes as no surprise that some of the recent MLP conversions are Perkins Stanley Restaurants, which is an operating entity, but has sig. R. E. write off, Andy Homes, a home builder, Motel 6, Newhall Land and Farming Co., which is essentially a residential developer. All are listed on the N. Y. stock exchange. Obviously you kick the dividends up if you don't have to leave 34% behind in a corporation.

The second thing it does is avoid unfriendly takeover, because it is much harder to remove a general partner than it is to unseat a corporate manager.

It also allows you to emphasize for your investor cash flow rather than earnings per share. You obviously have far more cash than earnings, because of a high degree of depreciation and amortization of debt and a variety of other non-cash expenses, so the investor feels he is doing better as a result.

The second reason is for corporate asset disposition. Typically the corporation sells its asset to a passive MLP entity and leases them back in a friendly not-so-arms length arrangement so you might have a series of three year renewal options - an off balance sheet kind of financing. You can sidestep FASB and not have to carry the assets on one side and on the back side as a liability. I'm sure Shidler will be talking to us considerably about this on Friday. The corp. that does this gets a considerable hype to its surplus in the year they take that deal. Let's say they have an industrial plant under a 35-40 year lease and they've used accelerated depreciation to write down the asset, but accounting requires they write off the 35 year liability of the lease as if it were a 35 year fixed interest loan. So what you have is a very significant imbalance. So if you sell the asset, you get cash for the asset, but glory wowsky the liability disappears, and that's a fairly large number. So the assets stay the same or go up by the cash you sold it for, and the liability comes off, so you get a large boost to your earnings per share. They get both the resale profit and clean up the balance sheet.

So lo and behold, all the Burger King restaurants are leased back to Burger King. The La Quinta Motor Inns were sold to their MLP then leased back to La Quinta. The nursing homes leased to Beverly Enterprises and Angel Care, Inc. Again, a way of corp. refinancing off the balance sheet - getting the fixed assets off, getting the cash flow in and allowing them to do a different thing or improving their working capital position relative to the service component of their business. This type of MLP is really an income vehicle. The potential for capital gain on highly specialized Burger King restaurants is really limited given the high rate of aging in styles of fast food stores. You can make an argument that you can write those off in about 15 years because of the modus operandi and the facade will change every 15 years, and they'll have to go into a rebuilding program. So it gives you a fairly rapid write off, and an income that's well sheltered.

The third is a way of buying assets for a corporation as an alternative to the REIT. they go out and buy properties which are currently in a limited partnership status, where the tax shelter has been exhausted, and they have a negative basis, and if they were to sell they would get hit with quite an income tax on their negative basis. The properties have appreciated, so we can go back and get non-recourse debt for a good part of the purchase, and notice that what you paid for it plus the non-recourse debt is part of your new basis. So the MLP can re-hype the depreciation game that the limited partnerships were playing before they got rolled up into the master.

Again, dep. on their structure, there may be tax deferred returns dep. on the financing they use. U. S. Realty Partners is a good example, EQK has an MLP called Green Acres, not related to the previous EQK property, which has a shopping mall and some other properties all rolled up into one MLP, providing much of the same character as an REIT, but with a little more basis. The REIT share owner's basis would be what he paid for the share, just like a corp. share owner, where the owner of the MLP share gets the kicker provided by the non-recourse financing, as he writes down distributions as capital dividend distributions. So the much heralded demise of the MLP has yet to occur, probably because Congressmen bought a good many of these and need to gradually disinvest before they change the law.

Q. Is the CEO of the selling corp. the Gen. Part. of the MLP?

A. Not if he's smart. He should set a corporate general partner - something which meets the safe harbor rule of 15% net worth. Maybe the parent corp. could be the GP. Notice in a lot of these cases, the management co. and the institution were joint venture partners, as with Krafcio and Equitable.

Q. Please review the difference between asset management and property management.

A. Property management brings you down to the net income line as "under current contract." Asset management is concerned with tomorrow's income. How much should we pay for tomorrow's income. Should we invest in asset enhancement? Should we buy out tenants that are not a credit to the entity. The asset manager is always out ahead of current operations. The prop. manager is always executing on current operations, and the financial manager is obviously concerned with how do you capitalize that structure now and into the long run.

Q. Re. termination date.

A. they would sell off and liquidate. One suspects that there is or already has been good communication among the inst. investors, so if we both have ones terminating, we would make a deal so this year I'll sell you mine and next year you sell me yours. We haven't made it so apparent that its churning, but we haven't really lost control of the property either. The Coldwell banker finite Trust was the first one to come to the end. They liquidated and sold off the property to a number of institutional investors at good profits - it worked beautifully and was really a hype to all the other finite trusts. Gee, it worked - look at all the money they made.

Typically they make the window with a good deal of flexibility - with a termination maybe ten years out and 2-3 years to complete the liquidation. There is a provision that 70% of the shareholders can extend it on a year-to-year basis, so if that window shows up right at a trough in the market, you have a way of postponing it without a forced sale. It's kind of a forced sale that's not. The IRS wants to be really firm - maybe.

Q. Rel. to spin-off shareholders.

A. They may be one and the same person. So if a corp. is spinning off its assets, each shareholders would get a pro-rata # of units in the LP. They now have both shares of stock and LP interests, and they can sell or keep both or either. That is a distribution in kind and not a taxable event. It is like a contingent sale - pretty hard to tax when you can't find a hard number from which to subtract your basis in order to come up with your gain. You get a piece of paper which says you now own 6 shares of EQK, that is kind of a mooshy return. Now when you sell it, you have a historical accounting record - so many dollars - so you pay the tax. At one moment you had 100 million of RE in the corp., and you owned nothing other than your share. One moment later you had 100 million of Real estate, and you still own your corporate share. It is really not quite clear what happened to market value. Where you go out and acquire other properties, and you roll it up, and say "your apt. project is worth 6 million with 4 million of debt, so you get 2 million in the new partnership which assumes the debt." Here market value is critical, so that kind of roll-up requires a precise appraisal, and that is where there can be trouble with IRS because a precise value is established. There is a tendency to undervalue so they can show a good profit on their assets once they put it all together. So a **roll up** is much more dependent on appraisal than a roll out. A **roll out** is where all the shareholders get their pro-rata share. Note that the corp. doesn't sell its asset on the rollout, but simply says instead of one piece of paper, now you have two pieces of paper, but your proportional share of ownership in both entities will be the same as before. If the corp. sold to another MLP, that would be a taxable transaction.

The final will be on Wed., May 4. The 857 final will be May 6.

Another critter not unlike the REIT is called the REMIC. Real Estate Mortgage Investment Conduit. Like the REIT, it is not a specific form of organization, but a set of qualifications which make you a REMIC or not. A trust, a corp. or even an MLP could be a REMIC. It exists in the mind of the IRS, not of state statutes. The REMIC grew out of the CMO - collateralized mortgage obligation. The CMO grew out of the idea that different investors are of a different degree of receptivity to getting their money back, and would like some protection against call. The original mortgage obligation was a complete pass thru. You never knew how much you were going to get or when you were going to get it. If interest rates rose, there was a tendency to get your money a little slower as prepayments slowed, and if rates fell, there was a tendency to get your money earlier as people tended to refinance. Just when you wanted the higher rate you thought you had locked in earlier, you got your money in the mail and had to reinvest it at the lower rate. To solve that problem, they created an investment which provided for different tranches of priority. A tranche is a cross section of the mortgage portfolio. What they said was "we'll have 5 tranches, and the first tranche will be paid off before tranches 2-5 get anything. This 1st tranche was a short term investment of 20-22 months credit enhanced by all of the other tranches. That is just about as good as U.S. Treasury money. It's like a zero coupon, when tranche 1 gets paid off, we start paying

tranche 2, & GO THRU THE SAME PROCESS. Tranche 2 is guaranteed by the money in the other 3 tranches, etc. Holders of tranche 2 were guaranteed they wouldn't have a call until the end of the 21st month or later. They had a defined term of investment. So depending on what you wanted - short term highly liquid and credit enhanced - or longer term, you could get it. That greatly enhanced the market for mortgages. What they said was, mortgages really represent a series of investments along the interest curve. As Mike Feiner put it, mortgage finance was shifted from the long term curve to the Treasury curve. The weighted average rate of interest on the tranches was considerably less than the contract interest on the mortgages. There was a tremendous amount of spread there.

The last tranche was what they called the residual tranche, and you can only have one of those. There are several sources of residuals. One is the fact that there may be some short time lag between the receipt of the interest or principal payment or the prepayment, and the coupon date on which it has to be paid out. Hence there is a reinvestment possibility. As reinvestment rates rise, the residual rates rise. Not only does the residual rate rise, but you enjoy a longer period of time of spread between the rate you are paying on the short term tranche and the mortgage rate, because there is less tendency for the home owner borrower to repay. A double kicker. Second of all, it has to do with costs to administer the portfolio. If interest rates rise too much, you obviously have more delinquencies and losses and foreclosures in the portfolio. Generally you over collateralize. You sell a hundred million of CMOs and you have 101 or 102 million of mortgages in the pot. So you have a little extra falling in the last tranche if foreclosures or administrative costs are lower than you forecast. So this tranche becomes a way of speculating on the loss experience of the portfolio involved. It really is almost a futures market kind of thing - based on the indirect consequences of the interest rate rising or falling relative to the volatility of the underlying mortgage. Recognizing you could never get an exact match between the mortgage revenues and your CMO coupon obligations, the last account is the clean-up account. If you own the last account, you can do very well. That was the executive perk to the officers at Salomon, etc., because of its great potential for profit. That's a REMIC.

Q. Is there a minimum size for those. A. It's pretty much a Wall Street operation -150-200 million because of the high fixed legal and underwriting costs. A. (to Q. on rates.) They go for about 25 basis points above Treasury for the first tranche up to about 75 basis points for the fourth. There is really no way to price the residual, which is the catchall - a high spec. kind of investment. It is the clean up account - the residual.

Why did the REMIC come into be. Under the previous tax law, if different classes of investors were taking their returns in different priorities, you were subject to tax as a corporation, and to avoid that it was necessary that the debtor keep the debt on his books. So if you were a homebuilding co., and you had 50 million in sales which you financed for all of your buyers, you had to keep that on your

books even though you sold it into this fund, because it was a contingent liability on the part of the originator and issuer. A somewhat uncomfortable position if you were kicking out a large # of mortgages. Further, if you had more than one tranche, Uncle Sam wanted to tax as a corp. unless all tranches were equal in amount, etc. The REMIC allows the issuer to have a complete sale of the mortgages so they are off his books, and they are no longer his liability and further allows the issuer to have more than one class with different coupon rates. Tranche A might be \$900 principal/unit with an 8% coupon. Class B might be a \$100 principal with an 11% coupon, because you were willing to wait and subordinate to class A. Then you have a residual class which says in essence after A and B are paid off, anything left goes into your class. The REMIC was simply intended to tidy up the bookkeeping, and get around the IRS technical interpretation of what determined a corp. and was subject to the double tax.

Originally the REMIC was intended to deal w/ residential mortgages - insured res. mortgages. If you are buying into a Wall Street security, you have no intention of looking into the houses in the pool or the credit of the borrower, you are buying a straight financial transaction. Therefore the two traditional sources of protection, the borrower and the property, just drop out of the mentality of the investor altogether. What is he looking for? He is looking for some form of credit enhancement. The old form of credit enhancement was the FHA. You didn't care about the borrower or the house, you looked to the FHA to get your cash, backed by the full faith and credit of the U.S. govt. In addition you are credit enhanced by the fact that if you are the first tranche, you are backed by all of the other tranches who have all subordinated their claims to yours. What could be more fair? You could care less about the real estate. We have detached the whole issue of the RE and the borrower from the generation of capital for the residential market.

Now along comes Salomon and Goldman Sachs and says this is terrific - great ability to arbitrage and make fees. Let's say the portfolio is largely southern California and we expect a higher delinquency rate there so we want to get out of it and buy one that is mostly Indiana and Ohio - not a bunch of newcomers who might get in the car and drive away at night and forget the mortgage. As a result the yields very subtly shift as people perceive the delinquency rate and default rate and price levels of the underlying assets shifting in different parts of the country. There is a great market in trading residential mortgages from different parts of the country. One third of the profits of Salomon Brothers in 1986 came from trading in CMO's of all kinds.

Now somebody gets the bright idea as they did in the old days of the mortgage trust, that worked so well for single family home loans guaranteed by the FHA and PMI business, what would happen if we did it with commercial loans. Terrific. Now they're putting together CMOs with commercial loans. But you can get to 300 million really fast with commercial loans. Now the problem is the Uncle Sam doesn't guarantee that, and there is some question whether the

private mortgage insurance industry should be insuring anything right now with VEREX and TICOR closed and a number of others not accepting new business. So they said gee, what we need is the blessing of the rating agencies: Moody's, Standard and Poors, and Phelps Dodge. The rating agencies are not selling out very quickly. Moodys has set up a whole set of standards as to the kinds of income properties they will look at. They have developed a model which analyzes the probability that the whole thing will go belly up and not be able to pay and the underlying real estate will not be adequate to cover the mortgage. So as a result the CMO applied to commercial mortgages is moving much more slowly. They don't have the credit enhancement, even though the investor has learned to expect that and two, once you get to wall street, there is no correlation between what you paid for the security interest and the real estate. Nobody is looking to the real estate. They are all looking to the credit enhancement. A number of insurance companies have stepped up - it remains to be seen how Travelers and Continental and a number of others do to provide guarantees on commercial loans. Everybody who has tried that in the past has come to regret it. They may too, but it provides additional fee income in the interim. The interest cost on a credit enhanced commercial loan is generally another 200 basis points above the rate. The only place it really works not too badly is where you are using tax exempt municipals, and even there it begins to move the interest rate well above what it should be. Watch a number of major housing projects in Madison and Milwaukee that were financed with tax exempt housing authority bonds. No provision is made in those bonds to call them and refinance them because interest rates fell. So what they are planning to do is default on the bonds, because when they default the tax exempt bond authority has the right to call all the bonds and refinance. When they do so, it will be at a much lower rate than those babies carry, and the cost of the credit enhancement will also come down, so the overall costs will be something the projects can carry, which they can't presently. So the commercial mortgage REMIC is kind of tottering along at the moment. The most successful one to date is (although a straight CMO - it was prior to the change in the law) was Provident Insurance in Philadelphia who had about a 600 million portfolio of commercial loans. They culled that and got rid of 200 million because they wanted to reposition their portfolio. They were able to CMO that mortgage pool. It remains to be seen what the REMIC will do in commercial real estate.

Okay. You should be able to compare the formats on control, liability, tax status, proceeds, ease of selling the security and raising money, the other elements that we talked about the other day, and you can add the finite REIT, the MLP, and the REMIC to that list. One other element and we'll call it a day: There are obviously a great many structurings that one can make for a real estate enterprise, in order to enjoy a tax law feature or a product liability feature or insure your despot control of the enterprise, and quite often you see real estate investment entities bent all out of shape to accomplish one or more of those objectives. Ultimately they get themselves into some form of difficulty where the incentive for choosing that form of organization is no longer true, such as we

saw in the recent change in the tax law and then comes the realization that the accounting costs more than the benefits. By and large we are getting back to really basics: Corporate ownership straight away double taxation, or two, a non-taxable institutional entity, which could be a closed or open end fund for pensions, an REIT, a REMIC, in which the draftsmanship is relatively simple and the adaption to changing times and changes in the tax law is relatively easy and the perils of inadvertently making a misstep relative to IRS rules, FASB rules, SEC rules, or public reporting requirements are minimized. All of the tax savings of being exceedingly clever can be lost from one stockpayer suit, even if the stockpayer loses.

The legal profession isn't necessarily rational on that. We are involved in a case currently where the damages, if the worst case were proven, which it can't be, would be \$530,000. But the irate shareholder, which happens to be the Marshall Field Trust which has 400 million in assets, has already spent a million dollars in legal costs, because they say "we will not be flim-flammed, and we will proceed at all costs against those who try to flim-flam the Marshall Field Trust." But the biggest flim-flammers of all are their attorneys, who have somehow not related back to the trust that they have now spent a million dollars, and are no nearer a settlement than they were when they began. There is no point to wandering into that morass of security, fiduciary, and shareholder law if you can avoid it.

Despite all the elegance of 47 ways to skin the IRS or the SEC, ultimately we get down to basics. We run into the simple one or two class share corporation, or into some institutional conduit which leaves the tax issue with the ultimate investor on a pass through basis, and all of the other nuances drop out.

Evan D. Harrison
The REMIC Rules

from Mortgaged Backed Securities, by Kenneth Love
Reading C for April 11, 1988, pp. 1220-1252

The REMIC is purely a creature of the IRS code. It represents a successful cooperation between the Congress and the private secondary market, and is the culmination of 7 years of secondary market developments. A REMIC may be a trust, corporation, partnership, or even a segregated pool within an entity. It permits the issuer to sell mortgages outright rather than hold them as collateral for CMO's, thus getting the asset and liability off its books and passing all tax through to the purchase of the mortgage backed securities.

FASB rule 77 and Technical Bulletin 85-2 govern, and permit issuance of REMICS to be considered a sale of the mortgages if certain conditions are met.

STRUCTURES

A REMIC may be a fixed investment trust which issues ownership certificates of pro-rata entitlement to all items of income and expense of the trust.

A REMIC may be an issuance of CMO's (collateralized mortgage obligations) by a corporation, where the CMO's are debt obligations of the corp. secured by mortgage assets of that corporation.

A REMIC may be an "owner's trust" used to issue multiple class securities. Certificate holders are lenders to the trust and receive distributions of the trust assets that secure the loan.

REMIC Impact: Holders of regular interests in the REMIC will be treated as holding debt obligations and holders of the residual interests will be taxed on the taxable income of the REMIC.

REMIC Requirements:

1. An election must be made on 1st year return to treat the entity as a REMIC. There are provisions to restore inadvertently lost REMIC status thru appeal to Sec. of Treas.
2. All interests must be either regular interests (specified principal and proportional-to-market fixed or objectively indexed variable rate interest, with timing, but not amount contingent on prepayments and investment income, all terms fixed on startup day. Treated as debt for taxes, but may take any form. May be issued in fast/slow pay, senior/subordinate classes like CMO tranches) or residual interests (one and only one class allocated pro-rata to a single class of investors, who receive diff. bet. actual investment income and payments at the assumed rate).
3. Substantially all assets must be qualified mortgages (can include mortgages, reg. interests in another REMIC, GNMA, FNMA, FHLMC pass throughs - just about anything secured by R.E.) and permitted investments (short term reinvestment of cash flow only until next regular payment date, reasonable reserves, and foreclosure property).
4. It must have a calendar year taxable year.

A REMIC must be a self liquidating pool of mortgages. Prepayments must be distributed. After the first three months, the REMIC cannot purchase or (except for disqualified mortgages during the first two years) replace mortgages.

Non REMIC multi-class CMDs can be issued until 1992, but the issuer must retain a residual interest, keep the collateral and debt liability on its books, be adequately capitalized and have debt payment intervals which do not correspond to receipt intervals.

If payments to goods and service providers are not deemed reasonable, they can be recharacterized as residual interests, which disqualifies the REMIC since it can have only one residual class.

The transfer of mortgages to a REMIC is tax free and the basis carries over, with pro-rata allocation to reg. and resid. interests. Either mortgage acquisition or issuance of interests can come first.

Costs of acquiring interests are capitalized, added to basis, which is fair market val. at transfer of assets acquired by REMIC. Diff. between basis and initial issue price of interests is taxable.

The REMIC must pay a penalty tax of 100% on the net income (gross income - allowable deductions which are directly related to transaction.) from prohibited transactions, which are 1. disposing of a mortgage except for qualified replacement, foreclosure, bankruptcy or insolvency of the pool, or qualified liquidation of the REMIC; 2. receipt of income not from a qualified mortgage or permitted investment; 3. receipt by the mortgage pool of any fee for services; 4. gain from disposition of any cash flow investment except upon qualified liquidation whereupon the REMIC will recognize neither gain nor loss on asset disposition if: (i) it adopts a complete liquidation plan, (ii) w/in 90 days sells all its assets and distributes proceeds to regular and residual interest holders, less assets retained to meet claims. Any reason for liquidating is O.K.

February 18, 1986

MEMORANDUM

TO: Graduate Students in Business 850

FROM: Prof. James A. Graaskamp

RE: Mr. Clifford Case

This case has a long history so that the dates are confusing. For purposes of estimating Mr. Clifford's net worth, please assume that he is 57 years old in 1986 so that the scenario which begins "In April 1978," really is referring to February 1, 1986 and that his company was just sold and that his manufacturing plant is now vacant at the beginning of 1986.

However, assume all dates of acquisition are correct and that the values attached to stock portfolios, etc. are current as of February 1, 1986.

Otherwise the dates should be ignored as there has not been time to rewrite the case to reflect a chronology consistent with your viewpoint as of February 1, 1986.

Your first assignment should make use of the MRCAP model. All the land values should be lumped into a single land asset; then each group of buildings can be treated as a single building so that all the real estate will fit on the lines available for depreciable assets. All stocks and bonds should be included in the initial working capital reserve and dividends plus appreciation treated as interest earned so that this reserve will be a proxy for non-real estate investments. The first objective is only to estimate the total net worth of Mr. Clifford, his taxable income, and the total income taxes he might now be paying; and finally, the approximate amount of cash required to pay federal and state taxes on his estate.

REAL ESTATE INVESTMENT PLANS OF MR. PAUL CLIFFORD

In April 1978 Mr. Paul Clifford owned a vacant one-story building in a suburb of Chicago, Illinois. He was confronted with the problem of what to do. Mr. Clifford employed a real estate consultant to advise him. The consultant has gathered information from Mr. Clifford and from other sources, but has not completed his analysis or developed his recommendations.

MR. CLIFFORD

Mr. Clifford was 57 years old and married. His two sons were grown and were well established in a business not related to Mr. Clifford.

In 1953 Mr. Clifford established the Clifford Manufacturing Company to manufacture electrical components. He had had previous experience in this type of business. He and members of his immediate family owned all the stock in the company. The company began operations in a leased building, but in 1956 Mr. Clifford purchased in his own name the land for the Clifford Building and in 1958 constructed the building. He then leased the property to the company and the company occupied it until the beginning of 1978.

According to Mr. Clifford the Clifford Manufacturing Company was successful and by 1965 he had funds to invest elsewhere. In early April 1978, Mr. Clifford explained his background in real estate to the consultant in the following words:

By 1965 I decided that real estate was a good investment for the long run. So I began to look around for income-producing property. I didn't want to get into residential rentals - either single-family or apartment units - because of the problems of dealing with tenants. Office buildings presented large capital requirements and I had no experience in the field. Since I knew something about manufacturing and distribution, I decided to try my hand at buildings used for these purposes. But I wanted to go slow and learn. I began to look around for possible buys.

In 1966 I bought a parcel of land with a one-story building containing 15,000 square feet. It was in the same town as Clifford Manufacturing and was suitable for wholesaling and light manufacturing. As this type of building goes, it was a small building.

Since things seemed to work out well in this first building, in 1968 I bought a 30,000 square foot similar building in an adjoining town.

In 1969 I bought a parcel of land containing seven one-story buildings with 100,000 square feet in an adjoining town. These buildings were similar to the earlier buildings purchased except they needed considerable repair to bring them up to a level to attract and hold desirable tenants. I had the repair work done over a period of time by my crew of five regular workmen.

In January 1977 I bought a 42,000-square-foot one-story building in another nearby town.

By the end of January 1977, I owned 11 buildings on five parcels of land located in four adjoining towns, with a total of 229,000 square feet of buildings. The properties were fairly close together - the two properties that were furthest apart were separated by about six miles. All the buildings were of the same general type. They were one-story buildings suitable for light manufacturing and wholesaling.

The buildings stayed occupied on the average about 90% of the time. Whenever I had a vacancy I ran a \$9.00 ad in a Chicago newspaper. I ran this ad about 20 weeks out of the year.

I also leased through real estate brokers. If a broker found a suitable tenant, I paid him the regular commission on the lease of 6% of the rent as collected during the first year and 3% thereafter for the term of the lease. About half of my buildings are rented through brokers. They can often locate prospects when I can't.

When I bought the seven buildings that needed considerable repair in 1969, I hired five workmen and have had them on the payroll ever since. There is an electrician, plumber, mason, carpenter and general handyman. They cost me \$90,000 a year. These men like to work for me because they get paid 52 weeks a year. I did not use them on the building occupied by Clifford Manufacturing, because under the terms of the lease the company was obligated to maintain the building.

Mrs. Brown, my secretary, keeps all the records on these buildings and keeps up with the paper work generally on them. She costs me \$15,000 a year. I spend \$575 a year on an accountant in connection with the Clifford Building.

I have never tried to keep records by individual buildings on cost of physical maintenance, but I estimate that on an annual basis it costs about 15¢ for materials and another 40¢ for labor per square foot of building. These estimates also include costs of maintaining the grounds around the building.

With the exception of the building that has been occupied by Clifford Manufacturing, all my buildings have been on gross leases. That is, I take care of all repair work on the buildings and supply heat and water for nonindustrial uses. The tenants pay for electricity and for gas and water used industrially. The tenants supply any

air conditioning equipment and pay for the cost of operating it. The tenants normally pay for improvements on the inside of the building, but this is something I will negotiate on. What I will do depends on whether the improvements would be of benefit to future tenants and how anxious I am to land the particular prospect.

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In leasing a larger building, I have found that I can get 15¢ to 20¢ more per square foot by breaking the building up among two or more small tenants rather than leasing to one large tenant. Also my risk is spread. If I lose one tenant, I still have rent coming in from the others in the building.

In January of this year I sold Clifford Manufacturing to a larger company in the same general field. The agreement was that this company would occupy the building until the end of March at no additional cost and then would move. The company wanted to consolidate all the operations at its own building. This explains why I have an empty building on my hands.

The Land and Building

The one-story Clifford building contains 42,000 square feet and is located on a parcel of land containing 190,000 square feet. Exhibit 1 shows the land and buildings and Exhibit 2 the details of the building.

The front of the lot is about three feet above the sidewalk and is level to the front of the building, which sets back about 110 feet from the sidewalk. The first section of the building is at this elevation. Beginning at the point where the first bend occurs in the building, the remainder of the building is a story lower. A stairway in the center of the back portion of the first section leads to the lower level. Beginning halfway between the front of the building and the first bend in the building, the land begins to get lower. The ground level along the lower section of the building facing the street is about a foot below the bottom of the basement windows and about two feet above the inside floor level. As Mr. Clifford pointed out, this section of the building appears

low when viewed from the front. However, on the back side of the building the ground level is about three feet below the inside floor level and continues to get slightly lower towards the west lot line.

On the south side of the lot, the elevation begins to decline halfway between the front of the building and the first bend in the building and continues until at the back side of the building the inside floor level is about three feet above the ground level. The land adjoining Mr. Clifford's property on the west is about two feet lower in elevation than is the west edge of Mr. Clifford's lot.

In the front of the building there is an asphalt-top driveway and parking area for about 12 cars.

The north end of the building has a large door that swings up making a truck-high loading dock. The area between the north end of the building and the side street has an asphalt top.

There are about six large trees on the lot.

To the northeast of the Clifford's property and in the same block are four two-story frame residences. These residences are over 30 years old and are occupied by the owners. Mr. Clifford shares in the ownership, along with the two abutting property owners, of a 40-foot wide driveway easement between the residential lot on the south and the lot across the easement to the north. This easement has never been used by Mr. Clifford. It is shown on Exhibit 1.

There are no easements on the Clifford property.

The land is zoned for light manufacturing and wholesaling.

The walls of the building are of cinder blocks and concrete blocks and contain large metal casement windows. The outside walls are coated with stucco. The inside walls are painted over the cinder blocks and concrete blocks. The tarpaper and tar roof is flat with pipe drains on

the outer walls to the ground below. The floor is three-inch concrete on a gravel base on top of dirt. The building is heated from a central boiler room, where fuel oil is used in the furnace. There are four fire walls that are indicated by the lines dividing the building in Exhibit 2. There are large heavy metal doors in the fire walls. The building is equipped throughout with a sprinkler system and with the ADT Service,¹ which costs \$300 a year.

The land contains 190,000 square feet (4.36 acres) and was purchased by Mr. Clifford in 1956 for \$15,000. This was 7.9¢ per square foot. In 1958 Mr. Clifford constructed the 42,000 sq. ft. building and put in the asphalt topping on the front and north side for \$243,000. In 1966 he installed the sprinkler system for \$22,000. The total cost of the building, therefore, was \$265,000. Mr. Clifford has depreciated the building and the sprinkler system at 4% a year. The building is in good repair.

The Clifford Manufacturing Company leased the property from Mr. Clifford for \$3,500 a month on a net lease basis. This was \$1.00 per square foot for the entire building on an annual basis. Under this net lease arrangement the company paid all the expenses, including taxes, in connection with the property. As Mr. Clifford explained, this was a common form of lease arrangement in Chicago when an entire building was being leased to one tenant.

Since the Clifford Manufacturing Company was responsible for all maintenance on the building and grounds, whenever something needed to be done a company employee was assigned to do it. Records were not maintained

¹The ADT (American District Telegraph Company) service provides a signaling device between the building and the office of ADT so that a signal is flashed in the office of ADT if the temperature of the building falls below 50° or if the sprinkler system goes off. When the signal is flashed, the ADT personnel immediately starts phoning a list of people supplied by the buyer of the service until someone on the list is reached and notified. Among the advantages of using this service is a lower insurance rate.

in such a way that the costs of labor and materials for maintenance could be determined.

For the past three years the cost of heating the building has averaged \$7,000 per year and the cost of water has averaged \$100. The taxes in 1977 were \$18,000. The cost of insurance has been \$1,000 annually.

Based on experience with his other buildings, Mr. Clifford in April 1978 believed that he could lease the building for about \$2.50 per square foot per year on a gross lease basis by leasing to several tenants and by making certain improvements discussed below. Under this gross lease arrangement, Mr. Clifford would maintain the exterior of the building, repair any defective pipes and wiring in the interior or exterior, and provide heat and water for nonindustrial uses. The lease would contain a tax escalator clause so that if the taxes on the property increased after the first year of the lease, the tenant would bear the full cost of the increase.

Mr. Clifford has developed the following estimates of the cost of preparing the building and grounds for leasing:

- | | |
|---|---------------|
| 1. Asphalt-top driveway from west side of building to lot line, parking area to southwest of building and driveway around south side of building connecting with parking area and driveway in front of building, and retopping present driveway and parking area in front of and on the north side of building. | \$20,000 |
| 2. Preparing the land for the asphalt topping | 5,000 |
| 3. Improvements to the building that would be required by tenants | <u>15,000</u> |
| 4. Total | \$40,000 |

Mr. Clifford estimated that it would cost him between \$8 and \$9 a square foot to construct this building in 1976; this would not include improvements to the land such as driveways and parking area.

Mr. Clifford had been told by a real estate broker that buildings similar to this building are selling in 1978 for approximately ten times the annual net income before depreciation, but that buyers are not interested unless the building is occupied by satisfactory tenants.

Mr. Clifford has been told by a mortgage broker that on buildings of this type insurance companies will lend up to two-thirds the value of the property if the building is occupied by satisfactory tenants.

The Surroundings

The tracks of the Chicago and Northwestern Railroad were adjoining the property to the south. There was a public siding on the south side of the tracks directly across from the property. The land on either side of the railroad tracks for several miles in either direction from the property was zoned for light manufacturing and wholesaling uses and there were large numbers of buildings devoted to these activities.

Across the street to the east of the property was a relatively new brick-front building with parking facilities in front and on the side. The building was designed for and was used as a lumber and building materials distribution center. All the lumber and materials were under roof. Adjoining the property on the west was a lumber yard with two large metal buildings and with lumber stacked outside. Across the street to the north was a public park and playground occupying the entire block.

The area to the north, northwest and northeast was an older residential area consisting of two-story frame houses. The area to the east and west along the railroad tracks contained light manufacturing and wholesaling activities. The area to the south, southeast and southwest contained a mixture of light industrial, wholesaling, retailing and residential uses.

Mr. Clifford believed that his property was well located from the viewpoint of accessibility both to the concentration of people and economic activity in and around the central business district of Chicago and to the larger Chicago metropolitan area. The property was located four blocks from U.S. Route 66, a major thoroughfare. By the way of Route 66 to the east, it was about seven miles to the central business district of Chicago. By way of Route 66 to the west, it was about three miles to I-294, which formed a semicircle around Chicago and its suburbs. Route I-294 began to the north of Chicago, swung to the east, south and west and ended up to the south of Chicago. Mr. Clifford pointed out that I-294 intersected all of the highways leading into Chicago and its suburbs and all of the highways leading out of Chicago to outlying suburbs and cities beyond. It had become a major route for servicing the Chicago metropolitan area.

Competition

The competition facing the Clifford building in early April 1978 was as follows:

There was an adequate but not excessive supply of buildings well located and similar to the Clifford building in the Chicago metropolitan area. The building had accessibility to the various parts of the metropolitan area; it was one story; there was a truck-high loading dock and more could be built; there was ample land for more driveway and parking space.

Similar space in the same town as the Clifford Building was bringing around \$2.50 per square foot per year on a gross lease basis when leased to smaller tenants.

In recent years there has been a considerable development of light manufacturing and wholesale buildings on I-294. Some of these were in well-planned and attractive industrial parks. The cheapest space available to smaller tenants on I-294 was \$2.35 per square foot per year on a gross lease basis.

There was an excessive supply of old buildings available in the central business district of Chicago at from \$0.75 to \$1.00 a square foot per year on a gross lease basis, but these buildings were not competitive with the Clifford building. They were multi-story, there was not adequate loading and unloading space, and there was no parking space. These buildings were often occupied by the garment industry, which needed a location easily reached by public transportation to serve its labor force.

Old mill buildings in towns further out from Chicago than this property could be rented for as low as 30¢ per square foot per year. But these properties were not competitive since they were multi-storied, were poorly located with respect to the Chicago metropolitan area, and often lacked adequate loading and parking facilities.

Exhibit 1

THE CLIFFORD BUILDING

Sketch of Land and Building

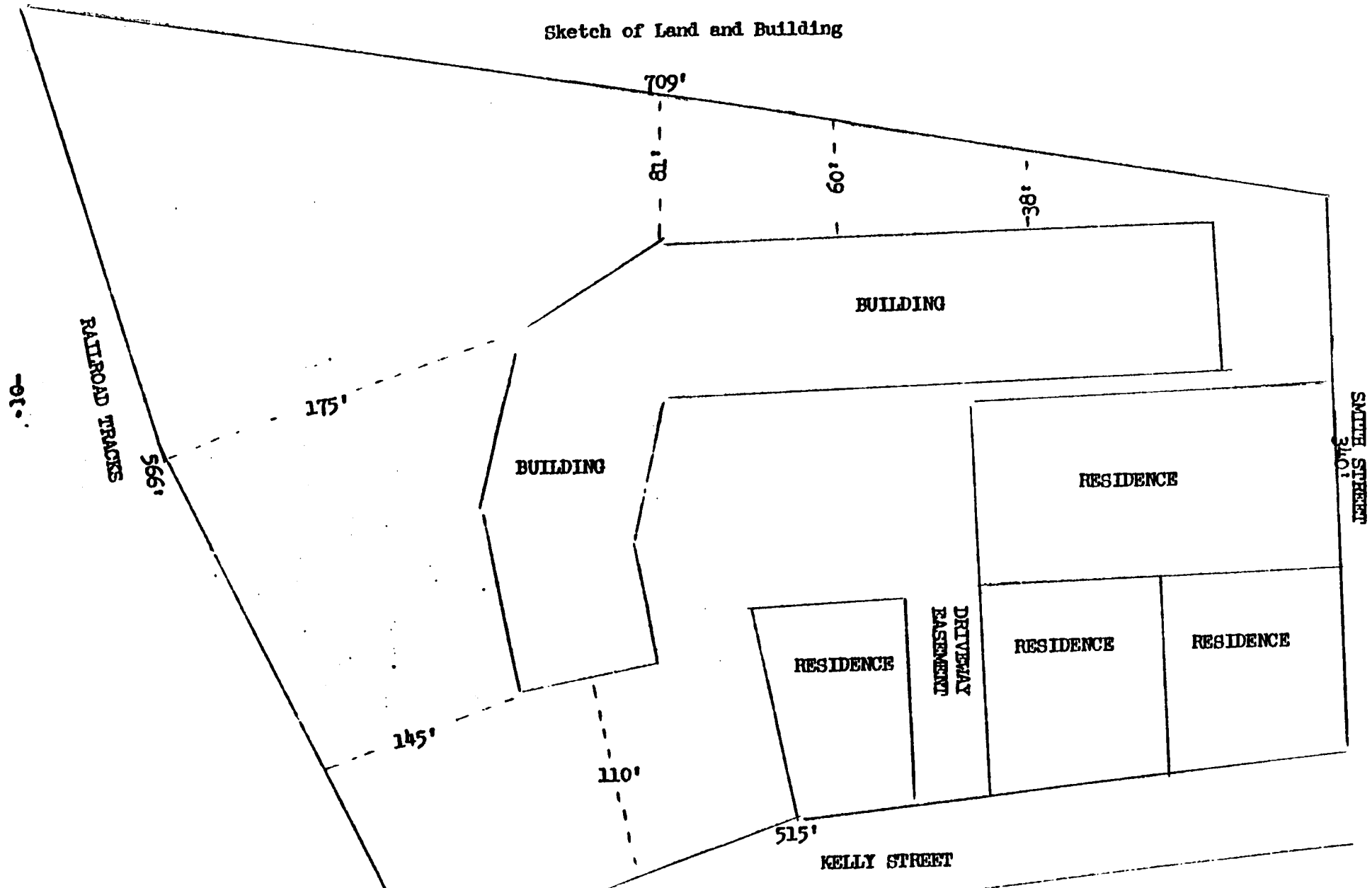


Exhibit 2

THE CLIFFORD BUILDING

Sketch of Building

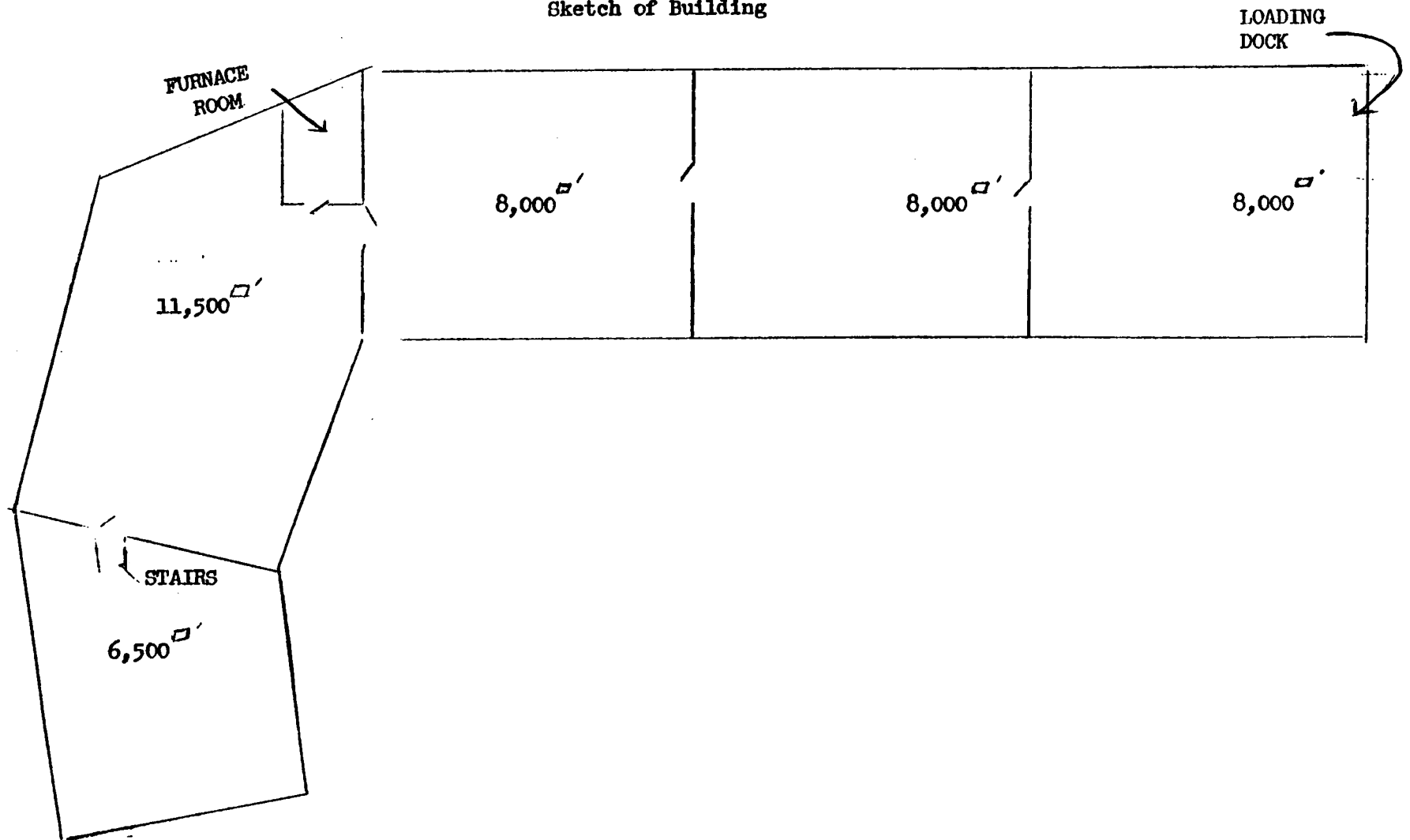


Exhibit 3

THE CLIFFORD BUILDING

Calculation of Annual Cost of Administration of Clifford Building

Based on Present Operation

Secretary (18.3% x \$15,000)	\$2,730
Accountant	575
Rent of office (18.3% x 4,800)	880
Phone and electricity (18.3% x \$620)	111
Office supplies (18.3% x \$600)	110
Advertising (18.3% x \$9.00 x 20 weeks)	33
Commissions on leases ¹ [$\frac{1}{2}(4\% \times \$43,107)$]	2,125
Automobile expense (18.3% x \$2400)	<u>450</u>
Total	<u>\$7,014</u>

Note: These costs are the estimated costs of administration as now carried on by Mr. Clifford with no allowance for compensation to Mr. Clifford for his efforts. Where an item of expense is attributable to all the building under Mr. Clifford's ownership and management, then 18.3% of the item is charged above to the Clifford Building. This is the relationship between the square feet in the Clifford Building (43,000) to the square feet in all the eleven buildings (229,000).

¹Based on one-half of the leases being negotiated by real estate brokers on a three-year basis. The commission to the broker is 6% of the rent the first year and 3% the second and third years. For the three-year period of the lease this averages 4%.

Exhibit 4

THE CLIFFORD BUILDING

Estimated Operating Statement for a New 21,000

Square Foot One-Story Building¹

Maximum gross rental income	\$52,500
Vacancy and loss of rent (10%)	<u>5,250</u>
Effective gross rent	47,250

Expense:

Taxes ²	?	
Insurance	?	
Administration	?	
Heat	?	
Water	?	
Repairs and maintenance	?	
ADT Service	?	
Accountant	<u>?</u>	<u> </u>

Net income before depreciation	?
--------------------------------	---

¹ Assumes a new building one-half as large as the present building and, therefore, assumes one-half the expenses of the present building except on taxes.

² Assumes that on present property 1/10 of the taxes are against the land and 9/10 against the building.

Exhibit 5

FINANCIAL DETAIL FOR ESTATE PLANNING OF MR. PAUL CLIFFORD

<u>Date</u>	<u>Property</u>	<u>Size</u>	<u>Cost</u>	<u>Land Cost</u>	<u>Original Financing Terms</u>
1955-56	The Clifford Building	42,000 sq. ft.	\$143,440	\$ 15,000	Owned free and clear
1966	Home Twon Building	15,000 sq. ft.	75,000	10,000	75% ratio; 15 year loan at 7½% interest
1968	Adjoining Town Building	30,000 sq. ft.	130,000	20,000	60% loan ratio @ 7½% interest for 15 years
1969	Industrial Park	100,000 sq. ft.	425,000	75,000	90% ratio land contract @ 8% for 20 years
1972	Nearby Town Building	42,000 sq. ft.	200,000	52,000	80% loan @ 9% for 12 years

Assume all buildings rent at \$2.50 per foot, an 8% vacancy loss per year, and an expense ratio not including brokerage of 40% of gross. Assume one half of properties are rented through brokers at 4% of annual rent on properties so leased. Assume it would cost \$40,000 to add sidetracks, individual access, and other features required in the Clifford Building. Assume depreciation on 90% of building cost at 3% per annum straight since purchase. Assume all repairs were expensed and did not affect tax basis. Assume Mr. Clifford wishes to maximize capital accumulation until he is age 70 and then enjoy an investment income for an inactive retirement. You may assume age 70 is reached in 1985.

Assume Mr. Clifford to have the following assets and income (excluding real estate assets and income):

- Common stock portfolio--\$500,000, providing 4% of value per annum in dividends and 2% per annum appreciation; average basis \$200,000
- Bonds--\$200,000 at an average rate of return of 6.5%, average basis of \$250,000, held more than one year
- Life insurance--face amount \$300,000, 65 full paid, average cash value presently 40%, annual net premium of \$7,000
- House--owned as joint tenants with wife, \$80,000, no mortgage
- Personal property (miscellaneous)--\$40,000
- Cash in banks--\$25,000
- Personal living expenses--\$25,000
- Wife's total net worth--\$150,000 (\$10,000 in jewelry and balance in securities with basis \$100,000)
- Average income tax deductions (excluding interest and depreciation)--\$10,000
- Miscellaneous husband and wife income--\$10,000

Financial Detail--Mr. Paul Clifford

Subject to a current tax rate on income, capital gain, estate, and gifts reported in Tax Planning for Real Estate Transactions, assuming these rates to reflect federal and state taxes combined.

- Problem #1: Calculate Mr. Clifford's approximate net worth, income after taxes, cash net after taxes and debt service. Suggest what problems exist in regard to his real estate holdings as indicated by this analysis.
- Problem #2: Establish the goals for his estate building program for Mr. Clifford and outline what must be done with the real estate to advance this plan.
- Problem #3: On the basis of the work sheet form Problem #1 and the goals established above, show the estimated 1985 net worth position of Mr. Clifford if he follows your real estate and estate planning suggestions.

REAL ESTATE INVESTMENT PLANS OF MR. PAUL CLIFFORD

In April, 1988, Mr. Paul Clifford owned a vacant one-story building in a suburb of Chicago, Illinois. He was confronted with the problem of what to do. Mr. Clifford employed a real estate consultant to advise him. The consultant has gathered information from Mr. Clifford and from other sources, but has not completed his analysis or developed his recommendations.

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Mr. Clifford was 63 years old and married. His two sons were grown and were well established in a business not related to Mr. Clifford.

In 1952, Mr. Clifford established the Clifford Manufacturing Company to manufacture electrical components. He had had previous experience in this type of business. He and members of his immediate family owned all the stock in the company. The company began operations in a leased building, but in 1955, Mr. Clifford purchased in his own name the land for the Clifford building, and in 1956, constructed the building. He then leased the property to the company and the company occupied it until the beginning of 1988.

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to the ground below. The floor is three-inch concrete on a gravel base on top of dirt. The building is heated from a central boiler room, where fuel oil is used in the furnace. There are four fire walls that are indicated by the lines dividing the building in Exhibit 2. There are large, heavy metal doors in the fire walls. The building is equipped throughout with a sprinkler system and with the ADT Service,¹ which costs \$1,200 a year.

The land contains 190,000 square feet (4.36 acres) and was purchased by Mr. Clifford in 1955 for \$15,000. This was 7.9 cents per square foot; land value in 1988 is \$1 per square foot. In 1956, Mr. Clifford constructed the building and put in the asphalt topping on the front and north side for \$143,440. In 1966, he installed the sprinkler system for \$11,690. The total cost of the building, therefore, was \$155,130. This amounted to \$3.69 per square foot. Mr. Clifford has depreciated the building and the sprinkler system at 4 percent a year. The building is in good repair.

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THE CLIFFORD BUILDING

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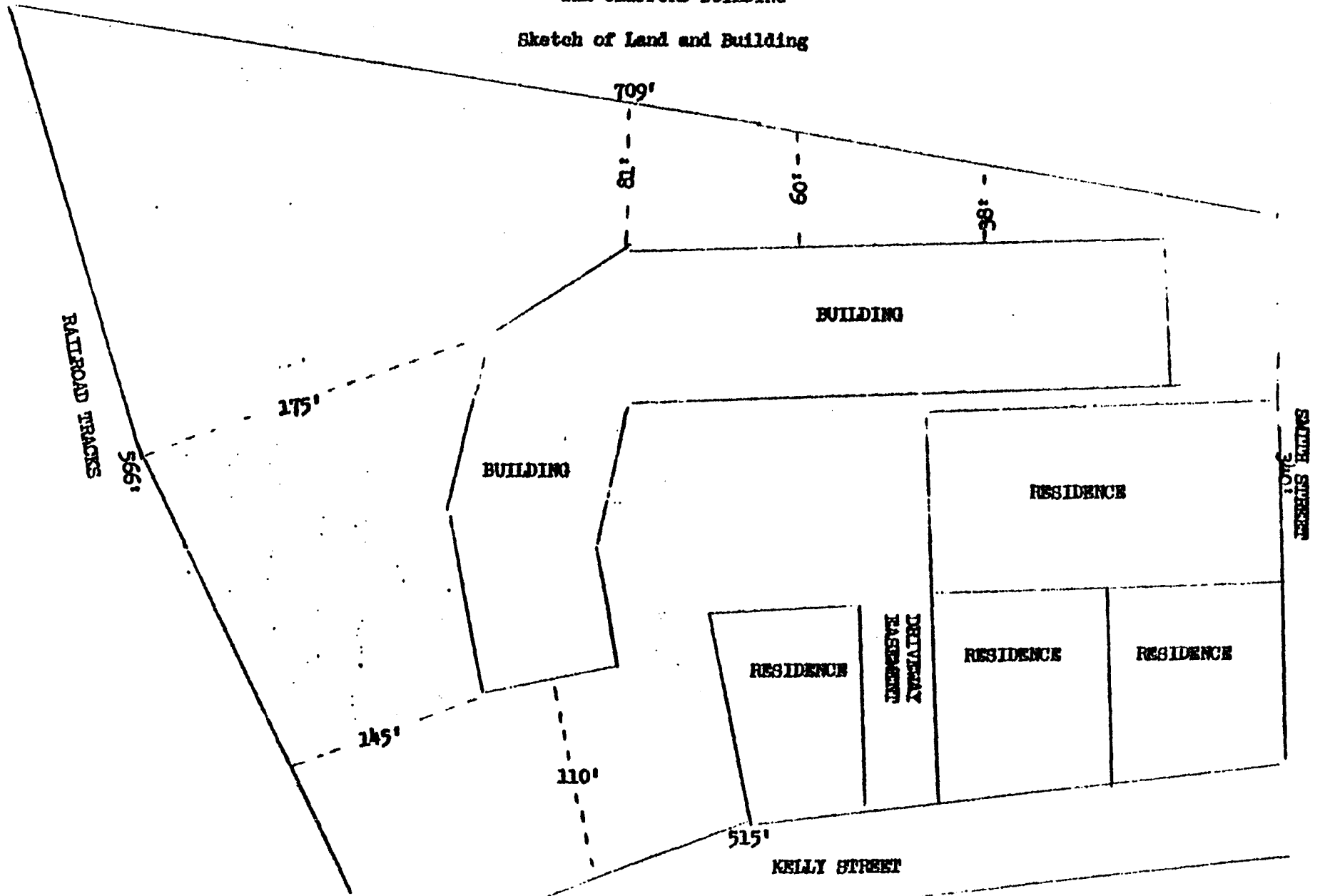
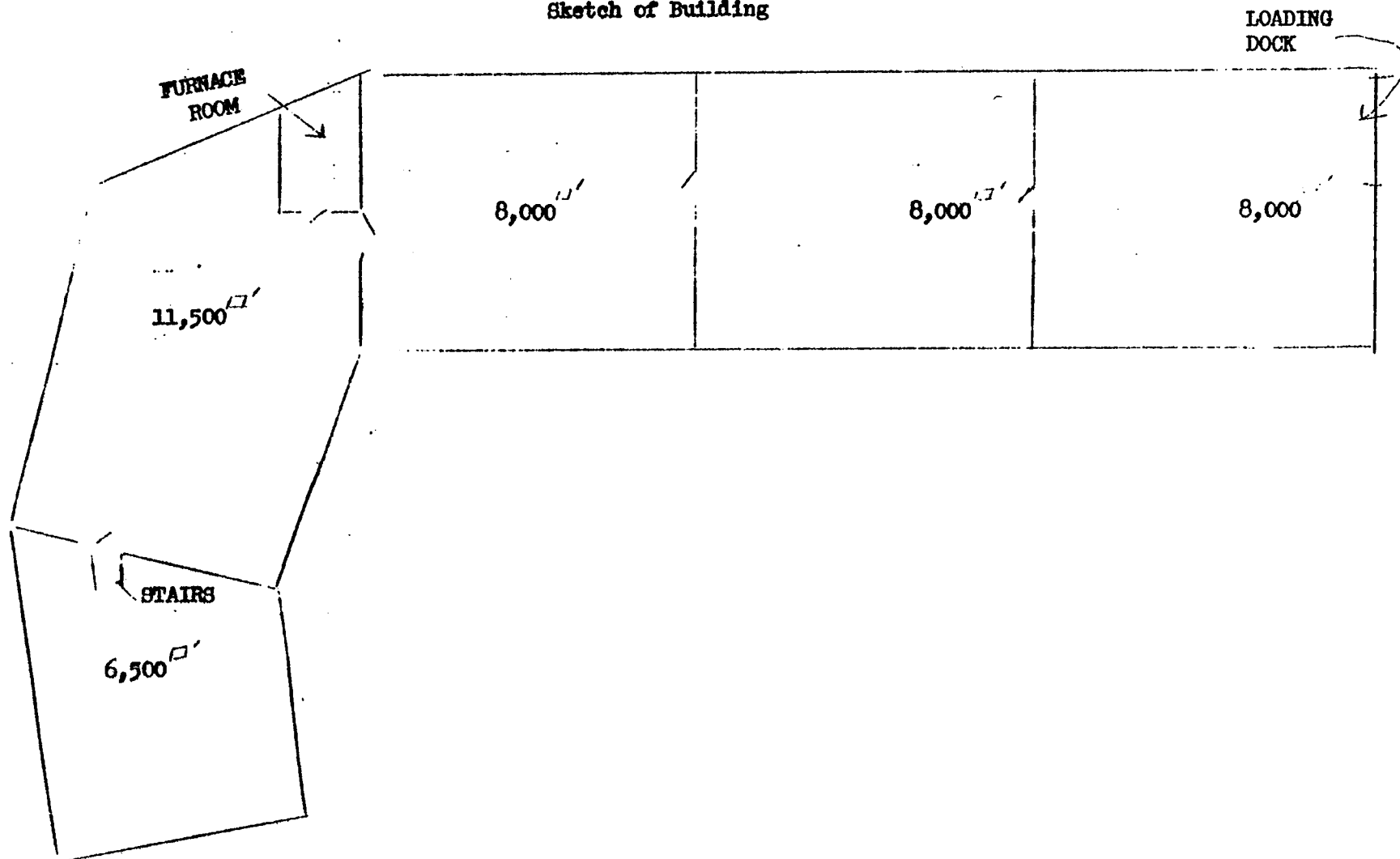


Exhibit 2

THE CLIFFORD BUILDING

Sketch of Building



Since the Clifford Manufacturing Company was responsible for all maintenance on the buildings and grounds, whenever something need to be done, a company employee was assigned to do it. Records were not maintained in such a way that the costs of labor and materials for maintenance could be determined.

For the past three years, the cost of heating the building has averaged \$23,600 per year, and the cost of water has averaged \$600. The taxes in 1987 were \$42,000. The cost of insurance has been \$4,000 annually.

Based on experience with his other buildings, Mr. Clifford in April 1988 believed that he could lease the building for about \$4.15 per square foot per year on a gross lease basis by leasing to several tenants and by making certain improvements discussed below. Under this gross lease arrangement, Mr. Clifford would maintain the exterior of the building, repair any defective pipes and wiring in the interior or exterior, and provide heat and water for nonindustrial uses. The lease would contain a tax escalator clause so that if the taxes on the property increased after the first year of the lease, the tenant would bear the full cost of the increase.

Mr. Clifford has developed the following estimates of the cost of preparing the building and grounds for leasing:

- | | | | |
|----|--|-------|-----------------|
| 1. | Asphalt-top driveway from west side of building to lot line; connect parking area and driveway in front of building with parking area to southwest of building and driveway around south side of building; and re-top present driveway and parking area in front of and on the north side of building. | COST: | \$29,240 |
| 2. | Preparing the land for the asphalt topping: | | 3,200 |
| 3. | Improvements to the building that would be required by the tenants: | | <u>60,000</u> |
| 4. | TOTAL - | | <u>\$92,440</u> |

Mr. Clifford estimated that it would cost him between \$30-35 a square foot to construct this building in 1988; this would not include improvements to the land such as driveways and parking areas.

Mr. Clifford had been told by a real estate broker that buildings similar to this building are selling in 1988 for approximately eleven times the annual net income before depreciation, but that buyers are not interested unless the building is occupied by satisfactory tenants.

Mr. Clifford has been told by a mortgage broker that on buildings of this type, insurance companies will lend up to two-thirds the value of the property if the building is occupied by satisfactory tenants.

The Surroundings

The tracks of the Chicago and Northwestern Railroad were adjoining the property to the south. There was a public siding on the south side of the tracks directly across from the property. The land on either side of the railroad tracks for several miles in either direction from the property was zoned for light manufacturing and wholesaling uses and there were large numbers of buildings devoted to these activities.

Across the street to the east of the property was a relatively new brick-front building with parking facilities in front and on the side. The building was designed for and was used as a lumber and building materials distribution center. All the lumber and materials were under roof. Adjoining the property on the west was a lumber yard with two large metal buildings and with lumber stacked outside. Across the street to the north was a public park and playground occupying the entire block.

The area to the north, northwest, and northeast was an older residential area consisting of two-story frame houses. The area to the east and west along

the railroad tracks contained light manufacturing and wholesaling activities. The area to the south, southeast, and southwest contained a mixture of light industrial, wholesaling, retailing, and residential uses.

Mr. Clifford believed that his property was well located from the viewpoint of accessibility both to the concentration of people and economic activity in and around the central business district of Chicago and to the larger Chicago metropolitan area. The property was located four blocks from U.S. Route 66, a major thoroughfare. By the way of Route 66 to the east, it was about seven miles to the central business district of Chicago. By way of Route 66 to the west, it was about three miles to I-294, which formed a semicircle around Chicago and its suburbs. Route I-294 began to the north of Chicago, swung to the East, south and west, and ended up to the south of Chicago. Mr. Clifford pointed out that I-294 intersected all of the highways leading into Chicago and its suburbs and all of the highways leading out of Chicago to outlying suburbs and cities beyond. It had become a major route for servicing the Chicago metropolitan area.

Competition

The competition facing the Clifford Building in early April 1988 was as follows:

There was an adequate but not excessive supply of buildings well located and similar to the Clifford Building in the Chicago metropolitan area. The building had accessibility to the various parts of the metropolitan area; it was one story; there was a truck-high loading dock and more could be built; there was ample land for more driveway and parking space.

Similar space in the same town as the Clifford Building was bringing around \$4.15 per square foot on a gross lease basis when leased to smaller tenants.

In recent years there has been a considerable development of light manufacturing and wholesale buildings on I-294. Some of these were in well-planned and attractive industrial parks. The cheapest space available to smaller tenants on I-294 was \$5.35 per square foot per year on a gross lease basis.

There was an excessive supply of old buildings available in the central business district of Chicago from \$1.75-2.00 a square foot per year on a gross leased basis, but these buildings were not competitive with the Clifford Building. They were multi-story, there was not adequate loading and unloading space, and there was no parking space. These buildings were often occupied by the garment industry, which needed a location easily reached by public transportation to serve its labor force.

Old mill buildings in towns further out from Chicago than this property could be rented for as low as \$.80 per square foot per year. But these properties were not competitive since they were multi-storied, were poorly located with respect to the Chicago metropolitan area, and often lacked adequate loading and parking facilities.

**FINANCIAL DETAIL FOR ESTATE PLANNING OF
MR. PAUL CLIFFORD**

<u>Date</u>	<u>Property</u>	<u>Size</u>	<u>Cost</u>	<u>Land Cost</u>	<u>Original Financing Terms</u>
1955-56	The Clifford Building	42,000 sq. ft.	\$ 143,440	\$ 15,000	Owned free and clear
1976	Home Town Building	15,000 sq. ft.	275,000	10,000	75% ratio; 15 year loan @ 7-1/2% interest
1978	Adjoining Town Building	30,000 sq. ft.	450,000	80,000	60% loan ratio @ 7-1/2% interest for 15 years
1979	Industrial Park	100,000 sq. ft.	\$2,000,000	200,000	90% ratio land contract @ 8% for 20 years
1982	Nearby Town Building	42,000 sq. ft.	800,000	100,000	80% loan @ 9% for 12 years

Assume all building rent at \$4.15 per foot, and 8% vacancy loss per year, and an expense ratio not including brokerage of 25% of gross. Assume one half of properties are rented through brokers at 4% of annual rent on properties so leased. Assume it would cost \$40,000 to add sidetracks, individual access, and other features required in the Clifford Building. Assume depreciation on 90% of building cost at 3% per annum straight since purchase. Assume all repairs were expensed and did not affect tax basis. Assume Mr. Clifford wishes to maximize capital accumulation until he is age 70 and then enjoy an investment income for an inactive retirement. You may assume age 70 is reached in 1995.

Assume Mr. Clifford to have the following assets and income (excluding real estate assets and income):

Common stock portfolio-- \$1,500,000, providing 4% of value per annum in dividends and 2% per annum appreciation.

Bonds-- \$1,200,000 at an average rate of return of 6.5%.

Life Insurance-- face amount \$300,00, 65 full paid, average cash value presently 40%, annual net premium of \$7,000.

House-- owned as joint tenants with wife, \$180,000, no mortgage.

Personal Property-- \$40,000 (miscellaneous)

Cash in Banks-- \$75,000

Personal Living Expenses-- \$65,000

Wife's Total Net Worth-- \$150,000

Average Income

Tax Deductions-- \$10,000 (excluding interest and depreciation)

Miscellaneous Husband
and Wife Income-- \$10,000

FINANCIAL DETAIL--MR. PAUL CLIFFORD

Subject to a current tax rate on income, capital gain, estate, and gifts reported in CCH Handbook, assuming these rates to reflect federal and state taxes combined.

TASK #1: Calculate Mr. Clifford's approximate net worth, income after taxes, cash net after taxes and debt service. Suggest what problems exist in regard to his real estate holdings as indicated by this analysis.

TASK #2: Establish the goals for his estate building program for Mr. Clifford and outline what must be done with the real estate to advance this plan.

TASK #3: On the basis of the work sheet from Task #1 and the goals established in Task #2, show the estimated 1995 net worth position of Mr. Clifford if he follows your real estate suggestions.

Use MR CAP to analyze this situation. Take the total land cost as a single entry and then treat each of the building complexes as a single capital component taking the original cost and subtracting the land cost for that complex. Treat the common stock, bonds, and life insurance cash as a single initial working capital reserve invested at 6% after tax. Once you have determined his net worth add back personal property such as the house, personal checking account and so on. Create an expense account which includes average income tax deductions. Don't be concerned with small accounting discrepancies, confusing precision with an accurate forecast of net worth for planning purposes. HINT: Assuming the date of analysis is 1988, enter only the remaining balance on any mortgages, the original constant and the interest rate rather than the original amount of the loan.

Section IV: Special Problem Cases - Case No. 20

Tanglewood Properties

Introduction

A group of six investors is interested in buying a package of properties owned by three partners in Dallas. The package consists of eleven separate apartment projects located in Austin and San Marcos, Texas. Initially, the investors were interested in only one of the projects - Tanglewood North in Austin. Further negotiations resulted in the investors purchasing the entire package of eleven properties.

Instruction Objectives

1. To expose students to the analysis of a decision involving a package of more than one property.
2. To analyze the structure and terms of a joint venture agreement.
3. To analyze the agreements made between a buyer and a seller in the sale of an apartment project.
4. To provide students an opportunity to analyze the structure of a financial package acceptable to the investors, the seller, and the lender.
5. To analyze the structure of the commission negotiated by the syndicators.

Background

In the fall of 1969, an Austin investor, Mr. Charles Davidson, was considering purchasing the Tanglewood North Apartment Complex, located on 45th Street in Austin, Texas. The complex was owned by a partnership of three Dallas men - Alan Liddell, Frank Liddell, and Charles Knappe. Mr. Knappe owned 50% of the property, with the Liddells sharing equally in the other 50%. Mr. Davidson and two investors were willing to put down about \$150,000 in equity cash on the project.

The Tanglewood Properties

The Tanglewood North complex was one of a group of eleven projects in the Austin and San Marcos area owned by the three Dallas partners. The projects were collectively known as the Tanglewood Properties, and consisted of the following apartment complexes:

Manor Villa - 2401 Manor Road - Austin

Chateau LeGrand - 1807 Poquito Street - Austin

Tanglewood East - 2604 Manor Road - Austin

Tanglewood West - 1403 Norwalk Lane - Austin

Tanglewood North (1) - 1020 E. 45th Street - Austin

Tanglewood North (2) - 1020 E. 45th Street - Austin

Regent - 1915 E. 19th Street - Austin

Timbers - 1307 Norwalk Lane - Austin

Villa Marquis - San Marcos, Texas

Stafford House - 22nd and Safford Streets - Austin

The other property in the eleven-property package, the Tanglewood West Annex at 1315 Norwalk Lane, was made a part of the Tanglewood West project for purposes of analysis.

The package represents a total of 456 units. The projects were mostly student apartments, with the exception of the Chateau, the Regent, and the Stafford House, which were predominantly occupied by adult, low-income blacks. A few of the apartment projects were in relatively sound financial and physical condition, with good investment potential - others were not doing well.

Problems Facing the Dallas Owners

As a result of mismanagement and partner disputes, most of the properties were in a negative cash flow position. The partners disagreed on how the projects should be managed, who or what was responsible for their adverse condition, and what to do to remedy the situation. Mr. Knappe was especially disenchanted with the whole deal, and wanted to sell the properties and terminate his partnership interest with the Liddells.

When Mr. Davidson approached the partners expressing his desire to buy the Tanglewood North complex, the partners offered to sell him the entire package of eleven properties. Following negotiations, they agreed on a \$3,201,000 price for the package deal, with \$400,000 of equity cash on the front end, leaving a balance of \$2,801,000 to be financed. Mr. Davidson agreed to take the proposal back to his investors to analyze the proposed investment package, and to determine whether or not he could raise the required \$400,000 in equity.

Financial Information

Supplied with the necessary supporting documents, Mr. Davidson generated the following financial data on the eleven properties for his analysis of the proposed investment:

Gross Income:	9 months at \$62,137/month =	\$559,233
	3 months at \$48,887/month =	<u>145,461</u>
	Total Gross Income	704,694
Less: Vacancy Allowance (7% of Gross)		<u>49,329</u>
	Gross Effective Income	\$655,365

Less: Annual Operating Expenses:

Insurance	\$23,100	
Utilities	43,500	
Taxes	73,000	
Trash Removal	5,642	
Maintenance & Repairs	38,500	
Professional Management	39,322	
Miscellaneous	38,500	
T.V. Cable	7,100	
Resident Manager	<u>24,608</u>	
Total Operating Expenses		\$293,272
Net Operating Income		\$362,093
Less: Annual Payment on Debt Service		<u>281,144</u>
Net Cash Flow Before Taxes		\$80,944

The Net Operating Income figure does not include the debt service payments required on the financing to buy the properties. The investors required a before-tax cash-on-cash return (ROE - cash flow before tax / equity investment) of 20%.

Income from the properties was highest during the Fall, Winter, and Spring months - September through May. Lower Summer rental rates and a softer apartment-rental market adversely affected the income-producing capability of the properties in the Summer months - June through August.

Factors Involved in the Investment Decision

Other factors were involved in the investors' decision besides financial information. Around 1969 and 1970, apartments in Austin were in high demand, especially the projects located near the University or near the shuttle bus route. Occupancy levels were high, rents were increasing, and the projections for the apartment market were optimistic. Besides the possible tax shelter typically offered by apartment investments, the projects also seemed to have the potential of generating substantial

positive cash flow. Overall, it looked like an opportune time to invest in good apartment projects in Austin.

Mr. Davidson has experience and background in property management. He and an associate investor were partners in several deals requiring their skills in real estate investment analysis and property management. The passive investors intended to utilize this knowledge and expertise in real estate to assume some of the required financial and managerial responsibilities of the properties.

Areas of Concern for the Investors

There were several drawbacks for the investors in settling the deal. First was the uncertainty of raising the required \$400,000 in equity. Mr. Davidson had been prepared to offer only a \$150,000 down payment. Either the present investors had to come up with the extra money, or additional investors would have to be found. Also, the financial and physical condition of some of the apartment projects would have to be further evaluated to determine their effect on the property's profit potential. Some of the complexes needed substantial repairs. Thirdly, mortgage money was extremely tight at that time, and the investors were concerned about the interest rate they would have to pay for the required \$2,801,000 financing.

The Decision

Based on a thorough analysis of the proposed investment, the investors decided to purchase the eleven properties, assuming they could obtain the required financing. The \$400,000 equity money was secured through the addition of two additional investors. Besides the initial two investors willing to put up \$75,000 each, the two others wanted to buy into the deal at \$100,000 each. This left the group \$50,000 short of the required \$400,000. Mr. Davidson and his associate managing investor agreed to contribute the additional \$50,000 needed to satisfy the equity requirement. The resulting ownership percentages were as follows:

1. A & B \$100,000 investors - 25% each
2. C & F initial investors at \$75,000 - 18.75% each
3. Mr. Davidson (D) and his associate (G) split the remaining 12.5% - 6.25% each

The land was valued at \$432,000, with the balance allocated to improvements. The properties qualified for the 125% accelerated depreciation method, and the improvements were to be depreciated over 20 years. The partners' average ordinary (marginal) income tax bracket was 50%.

Aware of the condition of some of the projects included in the package, the investors required a means of divesting some of the properties over the next few years without violating a sales or mortgage restriction. The negotiated mortgage, therefore, had to include a mandatory release clause to enable the investors to sell off individual projects in the package without forfeiture or penalty.

The Closing

An agreement was reached between the Dallas partners and the new group of investors on the terms of the closing. Details of the closing statement included the following information:

Sales Price: \$3,201,000

Expenses of Sellers:

Title Policy	\$9,233
Mortgage Policy	15
Recording Releases	15
Total Expenses	9,263
Less: January Escrow Deposits	4,323
Unearned Insurance Premium	4,451
Net Expense of Seller	\$ 489

Expenses of Investors

January Escrow Deposits	\$2,660
Special January Escrow Deposit	4,323
Unearned Insurance Premium	4,451
Recording	100
Total Expenses of Investors	\$ 11,534

These figures did not include commissions paid in relation to the sales transaction. The transaction was closed subsequent to the Dallas sellers' payment of the January escrow of \$4,323. The investors reimbursed the sellers for the January escrow payments. An additional \$2,660 in escrow payments was paid by the investors to supplement the escrow account. The net result of the closing was an additional \$11,534 outlay to the investors, in addition to the \$400,000 equity money.

Form of Ownership

The partners now had to determine the optimal form of ownership to employ in the operation of the properties. At the initial partnership meeting, Mr. Davidson, the partner with experience in real estate and property management, suggested a joint venture. Mr. Simpson, a 25% partner/investor, expressed his reluctance toward the suggestion by admitting that he was not very familiar with the joint venture form of ownership. For purposes of explanation, Mr. Davidson offered to draw up the

joint venture agreement and submit it to the other investors for their approval and comments at the next meeting. The investors agreed to Mr. Davidson's offer, and the meeting was adjourned.

QUESTIONS

1. What kind of a financial arrangement could be structured to meet the needs of the investors, the seller, and the lender?
2. Was this a good deal for the investors? Include a computer analysis of the investment to support your answer.
3. What agreements are made in a contract between the buyer and the seller in relation to the sale of an apartment project?
4. What is a joint venture? Compare and contrast the joint venture form of ownership with a general partnership. What are the responsibilities of the managing partner of a joint venture? What are the responsibilities of the managing partner of a partnership? What information is included in a joint venture agreement?

DEMONSTRATION OF THE USE OF THE INVESTMENT PARAMETER MATRIX

Investment characteristics of each investment vehicle have been related to a standard set of factors and scored for relative favorability on a scale of 1, 3, 5 with 5 being the most favorable. Raw scores for each class of factors can be weighed for compatibility with particular investment objectives. The sum of the weighed scorer may help identify the type of investment best suited for a particular investor.

Six classes of investment characteristics were selected:

1. Current Income
2. Short Run Risk
3. Long Run Risk
4. Long Term Appreciation
5. Liquidity
6. Entrepreneurial Skills

Each of the six classes of investment characteristics is composed of a set of investment parameters which affect the favorability of a particular investment characteristic.

For purposes of illustration the investment objectives of a particular investor are assumed. For purposes of simplicity the investment objectives will be defined in terms of the importance of a class of investment characteristics rather than in terms of specific parameters. Either method may be employed.

Assume: Investor A assigns the following weights based on the importance of each of the six investment characteristics.

1. Current Income	.10
2. Short Run Risk	.30
3. Long Run Risk	.20
4. Long Term Appreciation	.20
5. Liquidity	.10
6. Entrepreneurial Skills	<u>.10</u>
	1.00

Assume: Investor B assigns the following weights based on the importance of each of the six investment characteristics.

1. Current Income	.40
2. Short Run Risk	.10
3. Long Run Risk	.20
4. Long Term Appreciation	.00
5. Liquidity	.20
6. Entrepreneurial Skills	<u>.10</u>
	1.00

RAW SCORES FOR INVESTMENT CHARACTERISTICS

	<u>Farmland</u>			<u>Shopping Center</u>
	<u>Cash Rent</u>	<u>Crop Share</u>	<u>Livestock Share</u>	
I. Current Income	7	13	7	11
II. Short Run Risk	16	8	12	16
III. Long Run Risk	13	11	7	15
IV. Long Term Appreciation	16	14	12	12
V. Liquidity	16	16	6	12
VI. Entrepreneurial Skills	21	15	11	19

Raw scores are based on the relative favorability of an investment type to the investment characteristics. Explanation of the assignment of raw scores for farmland and shopping center investments are included in later sections.

INVESTOR A

	<u>Cash Rent</u>	<u>Crop Share</u>	<u>Livestock Share</u>	<u>Shopping Center</u>
I. Current Income	7 x .1 = .7	13 x .1 = 1.3	7 x .1 = .7	11 x .1 = 1.1
II. Short Run Risk	16 x .3 = 4.8	8 x .3 = 2.4	12 x .3 = 3.6	16 x .3 = 4.8
III. Long Run Risk	13 x .2 = 2.6	11 x .2 = 2.2	7 x .2 = 1.4	15 x .2 = 3.0
IV. Long Term Appreciation	16 x .2 = 3.2	14 x .2 = 2.8	12 x .2 = 2.4	12 x .2 = 2.4
V. Liquidity	16 x .1 = 1.6	16 x .1 = 1.6	6 x .1 = .6	12 x .1 = 1.2
VI. Entrepreneurial Skills	21 x .1 = <u>2.1</u>	15 x .1 = <u>1.5</u>	11 x .1 = <u>1.1</u>	19 x .1 = <u>1.9</u>
	15.0	11.8	9.8	14.4

Raw scores are weighed by the relative importance of the investment characteristics. Weighed investment characteristics are summed to indicate which investment type best suits investor A's investment objectives. Apparently cash rent farmland or shopping center investments are to be preferred.

INVESTOR B

	<u>Cash Rent</u>	<u>Crop Share</u>	<u>Livestock Share</u>	<u>Shopping Center</u>
I. Current Income	7 x .40 = 2.8	13 x .40 = 5.2	7 x .40 = 2.8	11 x .40 = 4.4
II. Short Run Risk	16 x .10 = 1.6	8 x .10 = .8	12 x .10 = 1.2	16 x .10 = 1.6
III. Long Run Risk	13 x .20 = 2.6	11 x .20 = 2.2	7 x .20 = 1.4	15 x .20 = 3.0
IV. Long Term Appreciation	16 x .00 = 0	14 x .00 = 0	12 x .00 = 0	12 x .00 = 0
V. Liquidity	16 x .20 = 3.2	16 x .20 = 3.2	6 x .20 = 1.2	12 x .20 = 2.4
VI. Entrepreneurial Skills	21 x .10 = <u>2.1</u>	15 x .10 = <u>1.5</u>	11 x .10 = <u>1.1</u>	19 x .10 = <u>1.9</u>
	12.3	12.9	7.7	13.3

Raw scores are weighed by the relative importance of the investment characteristics. Weighed investment characteristics are summed to indicate which investment type best suits investor B's investment objectives. Apparently shopping center and crop share and cash rent farmland investments should be considered.

It is possible to introduce greater variability into the weighed investment characteristic sums by either employing a wider range of raw scores or weighing investment parameters individually.

PRELIMINARY REMARKS: FARMLAND

This digest of investment parameters is based on discussions with Paul Craig, Wisconsin Farm Service, Inc., and Erlin Brannstrom, research associate, Dept. of Agricultural Economics, University of Wisconsin.

Each of the investment parameters have been discussed relative to three basic farm operation types: Cash rent, crop share, and livestock share. A more complete breakdown of the various enterprises has been suggested if further study of farmland investment is warranted.

by James Ablan
James Graackamp

April 1976

I. Current Income

- A. Cash on cash returns
- B. Tax shelter returns
- C. Control of timing of revenue stream

II. Short Run Risk

- A. Potential variance in revenue stream
- B. Potential variance in expense outlays
- C. Net income sensitivity to retail price level
- D. Time required to enter alternative land use plan

III. Long Run Risk

- A. Resale price sensitivity to retail price level
- B. Leverage
- C. Vulnerability to political environment

IV. Long Term Appreciation

- A. Cost of entry
- B. Equity build-up returns
- C. Price appreciation on resale
- D. Capital gain returns

V. Liquidity

- A. Search time
- B. Cost of entry
- C. Time horizon
- D. Sale time

VI. Entrepreneurial Skills

- A. Forecasting
- B. Political
- C. Planning and construction
- D. Leasing and marketing
- E. Property management

I. CURRENT INCOME

A. Cash on Cash Return

Major types of enterprises:	Cash Rent	Crop Share	Livestock Share
Return on cash investment:	8%	10%	8%

The above are historical averages for the past five years on equal shares, which have been adjusted for absentee ownership. Returns double those shown may be realized in the superior management.

Each of the major enterprises is a composite of several sub-categories. For example, under livestock, the return for feeder pigs was 14%, dairy cows 4%, and beef cattle 3%. The following breakdown is proposed by P.C.

<u>Cash Rent</u>	<u>Crop Share</u>	<u>Livestock</u>
Tillable Acres	Corn	Dairy Cows
Pasture	Soy Beans	Replacement Heifers
Buildings	Oats	Beef Cow-Calf
Houses	Hay	Feeder Cattle
	Wheat	Yearlings
	Peas	Feeder Pigs
	Sweet Corn	Sow to Finish

In the matrix cash rent, crop share and livestock share are scored 3, 5 and 1 respectively. In the near future grain farms are expected to yield higher returns due to better marketing skills and techniques utilized in a more favorable market. Crop shares are scored more favorably than cash rent

CASH
RENT

CROP
SHARE

LIVESTOCK
SHAVE

SHOPPING
CENTER

	1	2	3	4	5	6	7	8	9
	CASH RENT	CROP SHARE	LIVESTOCK SHARE			SHOPPING CENTER			
<u>I. Current Income</u>									
A. Cash on cash returns	3	5	1			5			
B. Tax shelter returns	1	3	5			5			
C. Control of timing of revenue stream	3	5	1			1			
TOTAL	7	13	7			11			
<u>II. Short Run Risk</u>									
A. Potential variance in revenue stream	5	3	3			5			
B. Potential variance in expense outlays	5	2	3			5			
C. Net income sensitivity to retail price level	5	1	1			5			
D. Time required to enter alternative land use plan	1	1	5			1			
TOTAL	16	8	12			16			
<u>III. Long Run Risk</u>									
A. Resale price sensitivity to retail price level	5	5	1			5			
B. Leverage	5	3	1			5			
C. Vulnerability to political environment	3	3	5			5			
TOTAL	13	11	7			15			
<u>IV. Long Term Appreciation</u>									
A. Cost of entry	5	3	1			3			
B. Equity build-up returns	5	5	5			5			
C. Price appreciation on resale	5	5	3			3			
D. Capital gain returns	1	1	3			1			
TOTAL	16	14	12			12			
<u>V. Liquidity</u>									
A. Search time	3	3	1			1			
B. Cost of entry	5	5	1			2			
C. Time horizon	5	5	3			5			
D. Sale time	3	3	1			1			
TOTAL	16	16	6			12			
<u>VI. Entrepreneurial Skills</u>									
A. Forecasting	5	1	3			5			
B. Political	5	5	5			5			
C. Planning and construction	5	5	1			3			
D. Leasing and marketing	1	1	1			3			
E. Property management	5	3	1			3			
TOTAL	21	15	11			19			

since the latter represents a fixed return while the former affords greater flexibility to capitalize on opportune marketing. Livestock shares are scored the lowest since political pressure will hold down product prices while increased feed grain costs will raise expenses.

B. Tax Shelter Returns

Agricultural operations are permitted use of the cash or accrual basis of accounting to their distinct advantage. Almost all tangible property may be depreciated on a componentized basis. Due to rapid technological advances in livestock management techniques, the functional obsolescence of buildings proceeds at a faster rate than the actual physical obsolescence. The IRS recognizes this fact and publishes guidelines for asset depreciation which reflect functional obsolescence. The functional obsolescence for farm machinery is more accentuated than for buildings. Depreciation is also permitted on breeding cattle such that while the cattle are increasing in value they are being depreciated. The conversion of feed protein to animal protein promotes conversion of ordinary income to capital gains. Cattle must be held for two years and must be for dairy or breeding purposes to qualify for capital gains treatment. Investment tax credit is permitted on all personal property (e.g., silos, cattle, milking machinery) up to \$100,000. Ten percent of the asset cost is a direct write off on the tax bill. A seven year holding period is required

to avoid recapture. Orderly improvement programs can maximize this advantage.

Livestock farms offer more tax cover since more depreciable assets (building, machinery, cattle) are involved. In the case of cash rent or grain farms it should be noted that unused buildings cannot be depreciated.

The scores for cash rent, crop share and livestock share are 1, 3, 5 respectively. Livestock farms permit the most tax cover from depreciable assets and promote the conversion of ordinary income to capital gain. Crop share operations can take advantage of cash accounting since purchases are expensed in the year purchased, and sales included in the year sold.

C. Control of Timing of Revenue Stream

Certain livestock and all grain farms may alter the revenue stream by controlling the timing of product sales. In particular, grain may be stored for sale at a more opportune time or may be sold on the future market.

Example:

In the last year grain prices have decreased \$1 per bushel.

300 acres at 125 bu/acre = 37500 bu x \$3.50/bu - \$131,250

300 acres at 125 bu/acre = 37500 bu x \$2.50/bu - \$ 93,750

29% loss

This loss could have been somewhat avoided by changing the normal revenue stream.

Livestock operations offer less control of revenues but more control of expenses since purchases of storable feed grain and hay will be reflected in the bottom line. In a livestock operation the conversion of feed protein to animal protein reaches a point of diminishing returns; expected market price increases must be substantial to warrant holding livestock once this point is reached.

Cash rent, crop share and livestock share are scored 3, 5, 1 respectively. Cash rental payments for land and/or buildings as determined in owner/renter negotiations usually include a portion of the crop as payment. This feature allows the owner some flexibility in the timing of crop share sales. Livestock sales face market prices and a constrained optimal sales time, thus there is little control of timing of revenue. As illustrated, grain operations offer the most flexibility in controlling the timing of the revenue stream.

II. SHORT RUN RISK

A. Potential Variance in Revenue Stream

Livestock and grain farms may produce orderly selling patterns based on production. With the exception of dairy farms, livestock production has more inherent variance than does grain production. Livestock prices have more variance than crop prices. In recent years the volatility of market prices has increased. Livestock production permits more managerial control in terms of animal husbandry practices and feed purchases. In livestock production feed costs represent at least 50% of the cost of production. Grain production is strongly dependent on the weather. Government policies are continuing major attempts to control and promote increased output. Grain farms have price guarantees in the form of loan guarantees should price expectation not be fulfilled. Dairy farm milk production enjoys very stable revenue flows since price floors are established by the Federal government.

The opportunity exists to choose enterprises which have favorable covariance characteristics. For example, when grain prices are high, grain farming is relatively profitable; high grain prices translate to high feed costs for livestock operations and consequently the profitability of feeder livestock enterprises will be depressed, vice versa.

Cash rent income is more stable than actual participation in the farming. Adjustments to rental rates usually follow grain market price trends by at least a one year lag.

Typically a cash rent position is in the form of a long term option to lease with the rental rate set on a yearly basis.

Cash rent, crop share and livestock share are scored 5, 3, 3 respectively. Cash rent is fixed at the beginning of the year, consequently there is little variance in the revenue stream. While livestock operations have the most inherent variance, they also permit greater managerial control. Consequently livestock share and crop share are scored the same.

B. Potential Variance in Expense Outlays

Controls of variable costs can be projected prior to enterprise entry. Orderly capital improvement programs can be followed. Total expenses are much more controllable than total revenues.

For grain farms a long planning time (Jan. 1-Mar. 1) permits more exacting estimates of expenses. Livestock enterprises have less control since the health of the animals and feed prices are more difficult to project. Expense variance in the cash rent situation can be contractually laid off on the lessee.

Cash rent, crop share and livestock share are scored 5, 3, 3 respectively. These scores parallel those for potential variance in revenue stream since the potential variance is a function of possible managerial control which is a function of the nature of the particular enterprise.

C. Net Income Sensitivity to Retail Price Level

The Consumer Price Index, a barometer of inflation, is in part composed of food prices (24.8%). Since 1972, the proportionate increases in food prices have outpaced increases in other goods and services measured by the index. However the increase in food prices is not reflected totally at the farm level; in fact, the farm retail price spread is continuing to widen, i.e., processors and distributors are receiving a larger share of the price increases.

Farm products fare market prices which are determined by supply and demand. While government policies have had the affect of increasing demand by increasing farm exports, government policies have also removed much of the control on supply. The result is that the market is given a freer rein in determining prices. The prices have been much more volatile.

Prices for feed grains (crop shares) are to a large extent influenced by exports. However large swings in prices have little effect on the retail price level. As feed prices increase, cattle feeding operations substitute grass for corn to cut feed cover and thus reduce the needed market price. The ability to do this has been increased by the USDA redefinition of meat grades. Now leaner beef (less corn and more grass feeding) can obtain the "choice" grade and market price. Even if feed substitution did not take place, the effect of large fluxuations in the market price for feed

grains would little affect the retail price level (CPI). The approximate direct and indirect effect on annual averages per capita food costs of a \$1/bushel change in the price of feed grain would be \$30. That is, if increases in grain prices were fully reflected in the prices of livestock products, the average annual increase in food costs associated with a \$1/bushel increase in grain prices would amount to slightly more than \$30 per person. Even a doubling of all grain prices would add less than 1% to the overall index.

Dairy operations have price supports on the demand side but are susceptible to cost push inflation on the supply side which is strongly influenced by feed costs. 80% of the price of milk is composed of the cost to produce the milk. 50% of the cost is for feed, 15% for capital costs and interest, 15% for labor. Therefore while milk prices may closely parallel the CPI the net price to the farmer may be at variance with the index.

Cash rent operations may allow a price level adjustment in the form of an annually renegotiated rental charge.

Cash rent, crop share and livestock share are scored 5, 1, 1 respectively.

D. Time Required to Enter Alternative Land Use Plan

For farming an alternative land use plan refers to an alternative farm plan. The flexibility to change enterprises will be constrained by the cropping cycle and the number and type of buildings on a particular farm.

A switch from cash rent to crop share may take a year depending on the contractual arrangement. A switch from cash rent or crop share to a livestock operation may take two years since buildings must be constructed, a herd must be purchased and an operator must be found.

If cash rent, crop share and livestock share are the only alternatives the time required to enter a more intensive use would be greater or conversely it is easier to change to a less intensive use. Therefore cash rent, crop share and livestock share are scored 1, 1, 5 respectively.

III. LONG RUN RISK

A. Resale Price Sensitivity to Retail Price Level

Between 1964 and 1976 the average price per acre of Wisconsin farmland rose from an index figure of 100 to 265 or 10% per year if a constant rate is assumed. In the past three years Wisconsin farmland has increased 20% per year on average.

In recent years grain prices have increased markedly. If buyers are multiplying these prices by the anticipated yields and capitalizing the net income, some of the phenomenal increase in land value may be explained. Present prices for farmland are based on future expectations. World population is ever increasing, there is finite cropland to support that population; exports of farm products (especially grain) are increasing.

In recent years the retail price level and the resale price for farmland have moved in the same direction; however, whether or not either is sensitive to the other is not documented. Net income appears to be rather insensitive to the retail price level, except in the case of cash rent wherein sensitivity can be contractually introduced. Price appreciation on resale is greatest for cash rent and crop shares. Most of the favorable future expectations are based on grain prices. For these reasons cash rent, crop share and livestock share are scored 5, 5, 1 respectively; this is more a reflection of past trends and hypothesized relationships than a postulate of existing documented facts.

B. Leverage

The net income and type of operation will dictate the degree of leverage desired. The volatility in commodity prices and the potential to store crops so as to realize revenue at opportune times reveal increased flexibility for low levered operations.

Agriculturally oriented banks in rural areas initiate mortgages for three to five years (longer amortization schedule with balloon payment) with payments to suit the particular farm. At the end of the period the bank will review the applicant and adjust the interest rate and/or amortization schedule. Crop share and cash rent typically make semi-annual or annual payments, while dairy farms make monthly payments.

Absentee owners are finding it increasingly difficult to obtain conventional mortgage financing in rural areas; the trend is toward land contracts.

A land contract will typically require a down payment of at least 30%, while conventional financing will require at least 35-40% down. When prices were more stable, a typical loan to value ratio was 50%. In the past five years loan to value ratios have varied due to short term financing and increased volatility in net income. The trend has been to establish lower loan to value ratios.

With cash on cash returns of 8-10% and short term financing, the possibility of negative leverage is present. The inability to convert appreciation in land value to cash available

to amortize a mortgage necessitates substantial holding power so as to realize an appreciable return in the long run.

Loan to value ratios on mortgages for land and buildings are similar for all three enterprise types. Livestock operations require greater equity investments (lesser leverage) than crop shares (see Cost of Entry). Crop share enterprises require greater equity investment than cash rent. According cash rent, crop shares and livestock shares are scored 5, 5 and 1.

C. Vulnerability to Political Environment

Politicians are accountable to consumers; consumers are affected by prices. The degree to which a given enterprise is removed from the retail market is a measure of its political vulnerability.

Livestock and milk production are marketed through processors to the consumer and are the most vulnerable to domestic politics. Produce from cash rent farms may be marketed through processors to consumers (vegetables) or to farmers (feed grains); in either case the cash rent position offers insulation in that it is removed from contact with consumer markets. Grain farms which market feed grains are substantially removed from consumer markets in that produce from grain enterprises is sold to livestock producers. Consequently, cash rent, crop share and livestock share are scored 3, 3, 5 respectively.

IV. LONG TERM APPRECIATION

A. Cost of Entry

To be efficient each type of farm operation has a different economic scale. Crop land ranges from 400 to 700 acres in size at prices ranging from 500 to over 1000 dollars per acre. Cost of machinery can range from \$60,000 to \$90,000 for a 600 acre farm. Cost for seed, fertilizer and chemicals for say 600 acres will be approximately \$40,000.

A livestock dairy cow operation will require 70-80 cattle and probably 250 to 300 tillable acres. Typically average dairy cows range in price from \$600-800 per cow. The cost of milking operation buildings is approximately \$60,000-70,000.

A typical feeder cattle herd ranges from 700 to 1,000 steers. Steers are purchased at a weight of say 700 pounds for say 30¢/lb. Thus a herd will cost between \$150,000 and \$200,000.

Certain enterprises will require ownership of personal property such as livestock, feed and machinery. Except for livestock these items should be held clear of debt since feed disappears and machinery depreciates faster than scheduled amortization payments.

The rankings are self-explanatory due to investment in:

Livestock Share:	Crop Share:	Cash Rent:
Land	Land	Land and/or Buildings
Buildings	Buildings	
Livestock	Crop Expenses	
Feed		
Crop Expenses		

B. Equity Build-Up Returns

Typically a land contract will have a shorter term and lower interest rate than will conventional mortgage financing. With a land contract, equity will build at a faster rate. Mortgages from agriculturally oriented banks will structure equity build-up to suit the particular farm. The short term nature of these mortgages permits increased flexibility in this respect.

All enterprise types will have similar financing terms and thus similar equity build-up with respect to land. Livestock operations have more financable buildings than do crop share enterprises; it is also possible to finance the livestock. Livestock enterprises will have greater potential for equity build-up since it is possible to finance more of the operation; however, livestock enterprises require greater equity investments.. Equity build-up returns for livestock share and crop share are given equal scores. Cash rent operations may have financable buildings and thus are scored similar to the other enterprises. All enterprises are scored 5.

C. Price Appreciation on Resale

Between 1964 and 1976 the average price per acre of Wisconsin farmland rose from an index figure of 100 to 265 or 10% per year if a constant rate is assumed. In the past three years Wisconsin farmland has increased 20% per year on average.

Cash rent farms are easiest to liquidate and in the last five years have realized the greatest appreciation in land value. Presently there seems to be greater appreciation in quality farm land for grain production which is reflected by the cash on cash returns. Since land represents more of the total investment for cash rent and crop share enterprises, and it is land that is appreciating, livestock enterprises will have lesser appreciation since components other than land may not have been fully depreciated at the time of contemplated sale. For these reasons cash rent, crop share and livestock share are scored 5, 5, 3 respectively.

D. Capital Gain Returns

All three operation types will permit capital gain returns on the sale of land and buildings; however, livestock shares offer some additional capital gain returns in that breeder cattle and dairy cattle held for more than two years are permitted capital gains treatment.

Cash rent, crop share and livestock share are scored 1, 1 and 3 respectively.

V. LIQUIDITY

A. Search Time

Search time for grain farms and cash rent opportunities is typically 6-12 months; search time for a livestock operation is typically 12-24 months.

Livestock farms require more search time since it is necessary to assemble more units of production. Search for a livestock farm must pay closer attention to economies of scale in the relation of land acres to buildings. Given the rapid technological advances in livestock management techniques, the economies of such an operation are in constant flux. While the search time for machinery for the various operations is the same, the purchase of the livestock and livestock feeds will require additional time.

The majority of farms transfer ownership on March 1st with contracts signed two to six months prior. The March 1st transfer date bears direct relation to the seasonal cropping cycle and the lead time needed to plan and get set up for the following year's operation.

Cash rent, crop share, and livestock share are scored 3, 3, 1 respectively.

B. Cost of Entry

Larger, more specialized, more costly enterprises are more difficult to liquidate. Sale of a livestock farm when the contemplated use is for crop shares will occasion difficulty since the prospective buyer does not plan to fully

utilize the buildings in their most productive use. Cash rent operations have the least capital improvements and are the most flexible in terms of liquidity. Crop shares have a liquidity position similar to that of cash rent enterprises. Coupled with this factor is the increased demand, i.e., greater willingness to accept cost of entry, for crop share operation.

Consequently, cash rent, crop share and livestock share are scored 5, 5, 1 respectively.

C. Time Horizon

The holding period for absentee investors usually extends ten years or longer depending on the investment objectives. The typical minimum is five years. It is a common practice to increase or decrease the original acreage. There is a seven year minimum to avoid investment tax credit recapture on personal property. Dairy and breeding cattle must be held two years to permit capital gains treatment.

Livestock operations require investments in buildings and permanent improvements and therefore require a longer holding period to recover the fixed investment. The carrying charge of a fixed investment retards flexibility of farmland crop alternatives.

Cash rent, crop share and livestock are scored 5, 5, 3 respectively.

D. Sale Time

Scores for sale time parallel those for search time. Although cash rent enterprises have been easiest to sell in the past, this trend is changing to favor crop share operations. Livestock operations require selling the herd and sale in a market which now favors crop share operations.

Enterprises are scored 3, 3, 1 respectively.

VI. ENTREPRENEURIAL SKILLS

Professional consultants for price forecasting, planning, construction, leasing, and marketing are available. Technical assistance in fertility (Least Cost Fertilizer Program) and nutrition (Ration Balancing Program) are available through universities. These resources must be utilized by a team leader or farm manager who possesses absolute authority regarding timely execution of decision making.

Cash rent operations will require price forecasting, leasing, marketing and technical assistance skills. Grain farms will require all entrepreneurial skills needed to produce and market the crop. Livestock operations will require all the skill needed to produce the crop as well as skills for matching the crop production with the livestock operation. "Agriculture is no place for amateurs." P.C.

As shown in the rankings, certain skills are more demanding than others, but management cannot be stressed enough in whatever sub-heading is considered.

HORIZON MALL
BORDERTOWN, TEXAS
CASE STUDY

Ira N. Keough, an acquisitions associate at JMB Realty Corporation, was entering John Wilson's office to review the potential acquisition of Horizon Mall Shopping Center. Ira had been at JMB for one year, and Horizon Mall represented the first major transaction for which he had primary responsibility. Ira had learned of this investment opportunity on a recent trip to Houston. After completing a market analysis (see Exhibit D) and financial analysis of the center, Ira had negotiated with the seller, Phil Meyers, president of Ace Development Company and developer of the center, for the past three weeks. The current status of negotiations is presented in the proposed letter of intent (see Exhibit A). At this stage in the acquisition process, Ira was scheduled to review the deal with John Wilson, a senior acquisition officer at JMB known for his keen analytical insight into real estate equity investments and his creative structuring techniques. With sweaty palms, Ira entered John Wilson's office.

At the outset of the meeting, Ira summarized the deal structure under which JMB Real Estate Limited Partnership VI ("JMB-VI") would purchase a 75% interest in Horizon Mall for \$6,000,000. (See Exhibit C for a summary of the investment criteria of JMB-VI).

Horizon Mall is an enclosed mall shopping center which contains approximately 420,000 square feet of gross leasable area of which JMB-VI would own approximately 311,000 square feet. The remaining 109,000 square feet is owned and operated by a J. C. Penney department store, which is physically attached to the mall. The other department stores in the center are Walmart (approximately 84,000 square feet) and Fair (a low to middle-price range, regional junior department store containing approximately 42,000 square feet). The remaining tenants include an Eckerd drug store (approximately 11,600 square feet), a General Cinema three-screen theatre (approximately 11,700 square feet), and approximately 161,700 square feet of mall stores. The mall is located on an approximately 75-acre site, at U.S. Highway 66 and State Highway 402 in Bordertown, Texas. Construction of the mall was completed in late 1979. Access to and visibility of the mall are excellent.

c. 1983, by JMB Realty Corporation. All names and facts have been modified. Phil Meyers and Ace Development Company are fictitious names and are not intended to represent any actual joint venture partner of JMB. This case was prepared for the Wharton School of The University of Pennsylvania.

Typically, investments in JMB-VI are evaluated on a pre-tax cash flow basis using a ten-year holding period. However, Horizon Mall was less than one year old, and nearly all tenants had signed leases at the prevailing market rent. Because there were few below-market leases in the mall, Ira believed that there was conceptual validity to valuing the mall based on a multiple of the stabilized year's net cash flow (i.e. "capping" stabilized cash flow), rather than using discounted cash flow analysis. He also realized that present value analysis would be highly sensitive to the inflation rate assumptions and residual value assumptions used in ten-year projections. The seller agreed with Ira's method for valuing the shopping center. Their disagreement centered on the appropriate stabilized cash flow projection.

After lengthy discussions with Phil, Ira believed that he understood Phil's objectives in selling a joint venture interest in Horizon Mall. First, Phil needed to finance all development costs for Horizon Mall. Total development costs, including future leaseup costs, were anticipated to be approximately \$20,300,000, of which \$14,300,000 had been funded by a first mortgage loan. Consequently, Phil needed at least \$6,000,000 cash from the sales transaction to fund the remaining development costs. Second, Phil hoped to make a profit on the transaction, although he was willing to forgo his profit if the mall's future performance did not meet certain achievement levels. Third, Phil wanted to retain as much equity in the mall as possible (Ira believed this to be at least 25%) in order to participate in the center's upside potential. The fact that Phil believed in the growth potential of this center (as evidenced by his desire to retain 25% ownership) was reassuring to Ira. Finally, Phil wanted to retain management of the center. The seller's needs, coupled with JMB-VI's investment objectives, had established the general parameters within which Ira had conducted the negotiations.

Ira and Phil had already agreed to buy the mall based on an 8% capitalization rate (or 12.5 times the net cash flow after debt service), reflecting current market yields for regional shopping malls in the sunbelt. However, Ira and Phil had been unable to agree on the mall's stabilized pro forma net cash flow on which the pricing was to be based.

Phil agreed that the stabilized pro forma net cash flow for the center would be approximately \$725,000 at 97% occupancy. Using an 8% capitalization rate, this equated to an equity value of \$9,062,500 or approximately \$6,800,000 for 75% of the equity. Ira on the other hand, valued the mall between approximately \$6,800,000 and \$8,000,000, and JMB-VI's ownership position (75% of the equity) at between \$5,100,000 and \$6,000,000. (see Pro Formas, Exhibit B). Based on his own assumptions concerning absorption of vacant space, market rents, and stabilized occupancy levels, Ira projected stabilized pro

forma cash flow to be approximately \$640,000. This translated into a valuation of the equity at \$8,000,000, consisting of a \$6,000,000 value for JMB-VI's position and a \$2,000,000 imputed equity position for Ace. Although Ira's market study suggested that the remaining space should be absorbed within 12 months, leasing activity at Horizon Mall had been sluggish during the previous six months. Ira was concerned that the mall might encounter difficulty attaining 95% occupancy. As a downside analysis, Ira used the center's current net cash flow of \$544,000 (based on 78% occupancy for mall stores) to establish a floor value for JMB-VI's position. Ira reasoned that since the current tenants had reasonably strong sales the mall should be able to sustain its current level of operations.

In addition to being uncertain about the stabilized net cash flow, Ira had a number of reservations relating to Ace, a potential joint venture partner of JMB-VI. While recognized for building high quality projects, Ace was not particularly adept at managing construction costs. A case in point was Horizon Mall where development costs had exceeded the original construction budget by approximately \$1,800,000. Furthermore, Ace had achieved inconsistent results as leasing agent and manager of other malls it owned. Ira was also familiar with a prior joint venture between Ace and another equity partner in which Ace had not always met its obligations under the partnership and management agreements. Finally, Ira had examined Ace's financial statements and concluded that while Ace had a net worth of approximately \$12,000,000, the bulk of its real estate assets were highly illiquid, and subject to the same real estate risks as Horizon Mall.

After Ira had completed his presentation, John responded: "Horizon Mall appears to be a fine long-term asset which we would like to add to JMB-VI's portfolio. JMB-VI is overcommitted to office buildings, so buying this asset will fit well in diversifying the fund, both by property type and location. However, there are a number of short-term risks that we should try to address in the deal structure. You and Phil have agreed to price the mall based on an 8% capitalization rate applied to a reasonable stabilized pro forma cash flow. However, the mall's stabilized net cash flow could be anywhere between today's level of \$544,000 and Phil's projection of \$725,000. This uncertainty is largely due to the fact that the mall is still in the leaseup phase. If we could take a snapshot 12 months from now, we could probably agree with Phil on the mall's value. However, as a JMB-VI investment we are required to make a deal today, providing up front for the allocation of the maximum dollars to be invested by the fund. One approach you might consider is to commit to a specific maximum dollar investment today, subject to some adjustment in the future. These type of deals are often difficult to administer and it is important to define precisely the mechanics of any future adjustment of price or ownership interest. One final thought relates to JMB-VI's current yield on the investment. You should be aware that we've bought a few

properties where tenancy and cash flow actually declined after closing. Under the current deal structure, JMB-VI receives an 8% preferred return (\$480,000) on its investment. Since current yield is an important investment criteria you might also try to receive a guaranteed yield for a specified period of time. From a negotiating standpoint, it might be helpful to offer Phil something as a tradeoff in order to get a deal structure which is acceptable to us.

Case Assignment:

- (1) Assess the risks and opportunities associated with investing in Horizon Mail.
- (2) Present a modified deal structure which addresses these risks, as well as the needs of both buyer and seller. (Ignore the tax structure of this investment.)
- (3) Evaluate the advantages and disadvantages of a joint venture deal structure. Pay particular attention to leaseup risk and JMB-VI's ability to gain protection through the joint venture structure (against Ace's potential failure to perform its obligations). Discuss the rights and controls which you think should be included in the joint venture and management agreements.

Note: The pro formas in Exhibit B are presented for illustrative purposes only. The important aspects of these pro formas are described in the case. The calculation of the pro formas is not intended to be a major focus of your analysis.

EXHIBIT A

(DRAFT)

July 28, 1980

Mr. Phil Meyers
Ace Development Corporation
101 Executive Lane
Secaucus, NJ

RE: Horizon Mall Shopping Center
Bordertown, Texas

Dear Phil,

This will outline the terms I discussed with you regarding the acquisition by JMB Real Estate Limited Partnership VI ("JMB-VI") of an interest, through a joint venture general partnership, in the recently completed Horizon Mall Shopping Center in Bordertown, Texas.

JMB-VI and Ace Development Company would form a joint venture general partnership ("joint venture") which would acquire the shopping center for a purchase price of \$20,300,000. JMB-VI would contribute \$1,000,000 as a down payment at closing (assumed to occur on September 15, 1980). On December 29, 1980, JMB-VI would contribute \$5,000,000, subject to the funding of a \$14,300,000 first mortgage loan from Alliance Life Insurance Company.

The joint venture partnership agreement would provide for a 75%-25% relationship between JMB-VI and your company as to cash flow and sale or refinancing proceeds. Taxable income and loss would be allocated in accordance with cash flow distributions, except that if there were no cash flow the allocation would be 99% to JMB-VI and 1% to you.

With respect to annual cash flow, JMB-VI would be entitled to receive a preferred return equal to the first \$480,000 of such annual cash flow, you would receive the next \$160,000, with any excess to be allocated 75% to JMB-VI and 25% to you. JMB-VI's preferred return would be cumulative for the first 24 months (cumulated to residual), and noncumulative thereafter.

With respect to proceeds of sale or refinancing, JMB-VI would first be entitled to receive any deficiencies in its cumulative preferred return and the next \$6,000,000 of such proceeds. You would receive the next \$2,000,000 with any excess to be divided 75% to JMB-VI and 25% to you.

Mr. Phil Meyers
July 28, 1980
page 2

Should any of the outlots be sold, the proceeds of such sales would be distributable 75% to JMB-VI and 25% to you.

The joint venture partnership would, at closing, enter into a management agreement with you under which you would manage the mall for an annual management fee equal to 3% of the rental revenues.

The foregoing is intended to reflect the items we discussed on Friday and to serve as the basis for further discussions. We still must review the leases and other documentation and further complete our market analysis, etc. prior to a final decision on the acquisition. Of course, no binding obligation on any party will be created until the execution of legal documentation satisfactory to all parties.

Yours very truly,

Ira N. Keough

cc: Sue Fourplenti, Esquire

EXHIBIT B

HORIZON MALL
BORDERTOWN, TEXAS
PRO FORMA STABILIZED NET CASH FLOW (\$000)

	<u>ACE</u>	<u>IRA</u>	<u>CURRENT</u>
Occupancy-Mall Stores Only	97%	95%	78%
<u>Income</u>			
Rental Income:			
Walmart (84,000 sq. ft.)	266	266	266
Fair (42,000 sq. ft.)	183	183	183
Mall Stores (185,000 sq. ft.)	<u>1949</u>	<u>1914</u>	<u>1763</u>
Total Rental Income	2398	2363	2212
Expense Reimbursements:			
Common Area Maintenance	336	336	285
Real Estate Taxes	125	125	110
Common Area Utilities	400	400	330
Marketing	70	70	60
Other Revenues	<u>10</u>	<u>10</u>	<u>10</u>
Total Revenue	3339	3304	3007
Vacancy Allowance	<u>(81)</u>	<u>(133)</u>	<u>-</u>
Effective Gross Income	3258	3171	3007
<u>Expenses</u>			
Common Area Maintenance	(300)	(300)	(282)
Real Estate Taxes	(125)	(125)	(125)
Common Area Utilities	(400)	(400)	(368)
Marketing	(70)	(70)	(70)
General and Administrative	(130)	(130)	(118)
Other Expense	(26)	(26)	(22)
Management Fee (3%)	<u>(70)</u>	<u>(68)</u>	<u>(66)</u>
Total Expenses	<u>(1121)</u>	<u>(1119)</u>	<u>(1051)</u>
Net Operating Income	2137	2052	1956
Less: Debt Service			
\$14,300,000; 9.25%;			
9.87k; 30 year amortization;			
20 year term	<u>(1412)</u>	<u>(1412)</u>	<u>(1412)</u>
Net Cash Flow	<u>725</u>	<u>640</u>	<u>544</u>

EXHIBIT C

INVESTMENT OBJECTIVES

The investment objectives of JMB Real Estate Limited Partnership VI are to provide Limited Partners:

- . Current cash distributions;
- . Capital appreciation through the increase in the value of the properties;
- . Federal income tax deductions so that all or a portion of the cash distributions during the early years of operation will be "sheltered" from taxes; (Ignore for this case)
- . Build-up of equity through the reduction of mortgage loans on the Partnership's properties.

INVESTMENT POLICY

JMB Real Estate Partnership-VI will invest in a diversified portfolio of income-producing real properties consisting primarily of existing commercial properties, such as shopping centers and office buildings. These properties will be located in various cities throughout the United States.

It is anticipated that the Partnership will use borrowed funds (leverage) in connection with the purchase of all or some of the properties.

The Partnership intends to hold the properties it acquires until sale or disposition appears to be most advantageous from the viewpoint of the Partnership and its investment objectives. It is presently intended that the properties will be sold or refinanced between the fifth and twelfth years after acquisition and the Partnership will seek to sell properties so that the average holding period for properties is between seven and eight years. However, the Partnership is not obligated to sell properties at any particular time.

The Partnership is self-liquidating in nature and no reinvestment of sale or refinancing proceeds in additional properties is permitted.

EXHIBIT D
MARKET REPORT
HORIZON MALL
BORDERTOWN, TEXAS
JULY, 1980

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II. MARKET ANALYSIS

This chapter contains an analysis of the retail market in Bordertown, Texas. The purpose of the analysis is to determine the market supportability of Horizon Mall. This analysis is based on demographic and economic trends, location and extent of competitive retail centers, and retail demand within the Bordertown trade area.

SUMMARY CONCLUSIONS

The market analysis of the Bordertown retail market indicates that adequate retail sales exist to support the 420,000 square foot Horizon Mall. Factors leading to this conclusion are:

- (1) Bordertown has enjoyed a steady population growth of 5.24% during the 1970's and future growth is anticipated to continue at this historical rate. The Bordertown - Plainville - Oakridge SMSA has been targeted by Sales and Marketing Management's 1980 Annual Survey as the second fastest growing SMSA in the country for the next five years.
- (2) Bordertown enjoys a dominant market share of department store type merchandise (DSTM) sales within its SMSA area. Typically, DSTM sales represent 18 to 22 percent of personal income in areas with a wide variety of retail shopping opportunities. In Bordertown, DSTM sales are approximately 100 percent of personal income, reflecting the large influx of commuter shoppers, particularly Mexican, to the area (see Table 9).
- (3) Bordertown benefits from its Mexican sister city of Hildago which had a 1979 population of approximately 300,000. Hildago lacks significant first class retail store space, and Bordertown area retailers benefit from Mexican shoppers who travel to Bordertown to shop.
- (4) Horizon Mall is located in the fastest growing section of Bordertown with significant residential development in the immediate vicinity of the Mall.

L. DESCRIPTION OF PROPERTY

Horizon Mall is an enclosed mall shopping center which contains approximately 420,000 square feet of gross leasable area of which the joint venture partnership will own approximately 311,000 square feet. The additional 109,000 square feet is owned and operated by a J. C. Penney department store, which is physically attached to the mall. The mall is located on an approximately 75-acre site, at U.S. Highway 66 and State Highway 402 in Bordertown, Texas. Construction of the mall was completed in late 1979.

The mall is of pre-cast concrete panel construction and has parking for approximately 2,300 cars. The first tenants occupied the mall in late 1979. The mall is presently 87% leased to 58 tenants (occupancy for mall stores only, excluding the department stores, is 78%). Tenants include J.C. Penney, which owns its store, a Walmart department store (approximately 84,000 square feet), a Fair junior department store (approximately 42,000 square feet), an Eckerd drug store (approximately 11,600 square feet) and a General Cinema three-screen theater (approximately 11,700 square feet). The leases have minimum lease terms (not including renewal options) of from 5 to 35 years and provide for minimum annual rentals ranging from \$3.16 per square foot to \$20.00 per square foot with an average annual base rental of \$7.09 per square foot. Substantially all of the leases contain provisions pursuant to which the lessor will be entitled to participate in gross receipts of the tenant over specified levels (percentage rental revenue) and also provide for the tenants to pay their pro rata share of real estate taxes, insurance premiums and certain common area operating expenses.

DETAILED MARKET ANALYSIS

PROJECT DESCRIPTION

Horizon Mall is a newly constructed regional shopping mall which contains approximately 420,000 square feet of gross leasable area. The anchors of the mall are a 109,000 square foot J.C. Penney, an 84,000 square foot Walmart, and a 42,000 square foot Fair junior department store. Retail mall tenant space comprises the remaining 185,000 square feet of gross leasable area. The mall provides approximately 2300 parking spaces for customers, and has additional land available for outparcel development.

SITE AND AREA DESCRIPTION

The mall is located in the northeast quadrant of Bordertown, on the northeast corner of U.S. Highway 66 and State Highway 402. The mall is visible from both highways, is well marked by signs, and has convenient access via an on-off ramp from U.S. 66.

In the immediate vicinity of Horizon Mall are the following:

- (1) Contiguous to the subject property on the north is Bordertown Country Club, a 700-acre residential community with an 18-hole golf course and 2000 residential home sites under development.
- (2) Located directly across State Highway 402 is La Plaza Apartment complex with 182 units.
- (3) Paredes Apartments, also on State Highway 402, has 152 units and is one half mile east of the subject.
- (4) Immediately west of U.S. Highway 66 and south of State Highway 402 are two motel complexes:
 - (a) Motel 6 with 120 units is currently under construction; and
 - (b) Holiday Inn with 159 units built in 1971.
- (5) Further south are the nearest competing retail facilities:
 - (a) North Park Shopping Plaza contains 115,000 square feet and is anchored by Kroger; and
 - (b) Bordertown Mall, containing 380,000 square feet, anchored by a Woolco Department Store and Aziz, a supermarket.
- (6) Other neighborhood improvements along U.S. 66 and State Highway 402 consist of local service-type facilities, retail stores, fast food restaurants, service stations, additional motel complexes, and general commercial facilities.

Horizon Mall is a ten minute drive from the central business district of Bordertown. Residents from any point inside the city limits can drive to the site within fifteen minutes. The dominant population growth in the Bordertown area has occurred north of Boca Chica Boulevard area and this trend will increase the trade population in immediate proximity to Horizon Mall.

DEMOGRAPHIC TRENDS AND PROJECTIONS

The City of Bordertown is grouped with the neighboring cities of Plainville and Oakridge for SMSA demographic reporting purposes. For economic and trade area analysis Plainville and Oakridge could be considered a separate, or secondary market area, based on the availability of exisiting retail space, distance from Bordertown, and the projected opening of a four-anchor regional mall in Plainville during 1983 or 1984.

Population

The population of Douglas County, in which Bordertown, Plainville, and Oakridge are located, was approximately 190,200 in 1979. Average annual population growth for Douglas County for the period 1970-1979 was approximately 3.94% (See table 1). Bordertown grew at an average annual rate of 5.24% during this period which represents a rate of population increase 33% greater than the county increase. Bordertown now contains over 40% of the resident population of Douglas County.

The general market potential for the entire SMSA area was highlighted by the 1980 issue of "Sales & Marketing Managements' 1980 Survey of Buying Power" which picked the Bordertown - Plainville - Oakridge SMSA (table 2) as the second fastest growing metropolitan area for the 1980 - 1985 period. In addition, the SMSA was the single metropolitan area out of the 25 markets with the highest growth rate from 1972 - 1977, which is expected to accelerate during the 1977 - 1982 period.

Table 2

**Fastest Growing Metropolitan Areas
1977-1982**

<u>Rank</u>	<u>S & MM Metro Market</u>	<u>1982 Population Forecast (000's)</u>	<u>% Growth 1977-82</u>	<u>1982 Household Forecast (000's)</u>	<u>% Growth 1977-82</u>
1.	Richland-Kennewick Wash.	151.5	28.5%	63.2	15.0%
2.	Bordertown-Plainville- Oakridge, Texas	236.7	25.0	72.6	33.5
3.	Rapid City, SD	116.1	24.7	40.7	32.6
4.	Fort Myers, Fla.	207.1	23.6	86.8	30.9
5.	Santa Cruz, Cal.	204.7	22.6	87.4	30.1
6.	Olympia, Wash.	123.9	21.4	47.5	38.0
7.	McAllen-Pharr- Edinburg, TX	286.7	20.0	79.8	26.1
8.	Provo-Orem, Utah	217.5	19.8	61.4	24.8
9.	Las Vegas, Nev.	427.8	18.9	160.4	25.4
10.	Austin, TX	574.7	18.8	198.1	24.1

Bordertown also benefits from its Mexican sister city of Hildago which had a 1979 population of approximately 300,000. The existing economy is agrarian and considerably inferior in per capita income and standard of living to Bordertown. The near term potential for Hildago is influenced by the availability of inexpensive labor and energy. The Mexican government is providing for the growth of industry through urban improvement and industrial bond financing in the Hildago area. The residents of Hildago use Bordertown as their major retail center. As the Mexican government provides an increasing base for economic growth, the Hildago residents will have greater disposable income to spend at Horizon Mall and in other Bordertown shopping areas.

Income

Per capita income in the Bordertown - Plainville - Oakridge SMSA, although modest, has exhibited steady growth during the period from 1972-1977. The per capita income of \$3,020 in 1977 represents a 50% increase over the 1972 per capita income of \$2,014. Coupled with the significant annual population increase noted above, the SMSA is generating substantial increases in purchasing power.

Table 1

**Population Trends and Estimates
Douglas County and Major Cities
1970-1979**

<u>Year</u>	<u>Bordertown Population</u>	<u>Percentage of County Pop.</u>	<u>Plainville Population</u>	<u>Percentage of County Pop.</u>	<u>Oakridge Population</u>	<u>Percentage of County Pop.</u>	<u>Douglas County Population</u>
1970	54,892 (1)	39.11	33,503(1)	23.87	15,176(1)	10.81	140,368(1)
1974	64,900(2)	38.82	41,400(2)	24.76	17,900(2)	16.71	167,200(2)
1979	80,800(2)	42.48	46,500(2)	24.45	17,400(2)	9.15	190,200(2)
Average Annual Rate of Growth	5.24%		4.31%		1.63%		3.94%

(1) Source: 1970 U.S. Census

(2) Source: Sales & Marketing Management Survey of Buying Power

Employment

The employment base of the Bordertown area is undergoing substantial growth and diversification fueled by the availability of lower labor costs and dynamic petrochemical industry along the Gulf Coast. Tables 3 and 4 list major corporations and manufacturers located in the Bordertown area.

Unemployment statistics reflecting the unemployed portion of the Douglas County workforce from 1977-1981 are outlined below:

Unemployment Rates Douglas County 1977-1981				
1977	1978	1979	1980	1981
11.4%	10.2%	8.9%	10.5% (Est.)	10.5% (Est.)

Source: Texas Employment Commission, Bordertown Office

The figures tend to reflect the growing pains of an increasing population and a rapidly changing industrial and economic environment.

RETAIL SUPPLY AND DEMAND ANALYSIS

Retail Supply

A total retail supply of 1.2 million square feet exists in Bordertown excluding Horizon Mall (see Table 5). Horizon Mall's major competition is the Amigoland Mall consisting of 650,000 square feet of gross leasable area and anchored by Sears, Dillards, and Montgomery Ward. A new mall currently is planned for Plainville in 1983 or 1984 which could attract some shoppers who have in the past commuted to Bordertown to shop.

Table 3

BORDERTOWN, TEXAS — AREA FORTUNE 500 COMPANIES

RANKING

1	GENERAL MOTORS CORPORATION	Automotive Components
2	EXXON	Petroleum Tank Farms
5	TEXACO	Petroleum Tank Farms
11	ITT AUTOMOTIVE ELECTRICAL PRODUCTS	Automotive Components
16	E. I. DUPONT DE NEMOURS	Chemicals
21	UNION CARBIDE CORP./3 DIVISIONS	Chemicals, Electronics, Air Separation
28	HALLIBURTON COMPANY	Drilling Chemicals & Barite
69	WEYERHAEUSER	Corrugated Boxes
75	BENDIX	Electronics
78	CONSOLIDATED FOODS CORPORATION	Seafood Processing
95	DRESSER INDUSTRIES	Drilling Mud
101	EATON CORPORATION	Electro-Mechanical Devices
113	SINGER/GENERAL PRECISION	Electronics
124	COMBUSTION ENGINEERING	Ores
176	QUAKER OATS/FISHER PRICE TOYS	Stuffed Toys
177	LEVI STRAUSS & COMPANY	Apparel
228	SUNBEAM CORPORATION	Electronics, Appliances
236	MCGRAW EDISON CO.	Electrical
259	ZENITH RADIO CORP.	Electronics
264	THE NORTON CO.	Abrasive Sand Paper
270	PENNWALT CORPORATION	Fluorspar Pellets
289	GENERAL CABLE CORP./SPRAGUE ELECTRIC	Electronics
331	PARKER-HANNEFIN/PARKER SEAL & IDEAL CORP.	Rubber Seals, Automotive Components
366	SHELLER GLOBE CORPORATION	Fractional Horsepower Meters, Meters, File Folders
482	PENN CENTRAL CORP./MARATHON LETOURNEAU	Offshore Drilling Platforms

Source: Bordertown Chamber of Commerce

Table 4

BORDERTOWN, TEXAS — AREA MANUFACTURING COMPANIES

COMPANY

MITSUBISHI/KAWASAKI STEEL/RIVER STEEL
EAGLE INT'L WORLD MFG. HEADQUARTERS
AQUASLIDE'N DIVE CORP.

HAGGAR COMPANY
CTS CORPORATION
CARLINGSWITCH
CUTLER HAMMER
DURO PAPER BAG MFG. CO.
NORTHERN ELECTRIC CO.
RANCO CORP.
WINEGARD CO.
AMERICAN SAFETY EQPT. CORP.
CRC CROSE INT'L/CRC KELLEY PRODS.
TECCOR ELECTRONICS
LEONARD ELECTRIC PRODUCTS CO.
VAREL MFG. CO.
AMPLIFONE CORP.
PYRAMID MFG. CO.
PETRACO-VALLEY OIL & REFINING CO.
GULF ENERGY & REFINING CO.
BARBOUR ENERGY CO.
HALLIBURTON CO./IMCO SERVICES
FINNING TRACTOR & EQPT. CO./CANADA
ERICKSON BROS.
OGLEBAY-NORTON CO.
OZARKE-MAHONING CO.

Construction Eqpt. Components
Trailways Buses & Coaches
Fiberglass Swimming Pool Diving
Boards, Slides
Apparel
3.5 To 15 Inch Speakers, Electronics
Electronics
Electronics
Paper/Plastic Shopping Bags
Electronics, Appliances
Electro-Mechanical Devices
Electronics
Automotive Seat Belts
Construction/Handling/Mining Eqpt.
Electronics
Electronics
Petroleum Drill Bits
Transformers, Electronics
Onshore Drilling Rigs & Platforms
\$400-Million Refinery
Petroleum Refinery
\$750-Million Oil Refinery
Barite & Drilling Chemicals
Caterpillar Eqpt. Refurbish Operation
Nickle-Chrome Plated Truck Parts
Fluorspar Pellets
Fluorspar Pellets

Source: Bordertown Chamber of Commerce

Table 5

**Major Competing Retail Developments
Bordertown, Texas**

<u>Key</u>	<u>Name</u>	<u>Total Gross Leasable Area Sq. Footage</u>	<u>Major Tenant</u>	<u>Square Footage</u>	<u># of Mall Shops</u>
1	Amigoland Mall Regional enclosed mall Melvin Associates Opened January 31, 1974	650,000	Sears Dillards Wards	136,326 108,860 114,969	82
2	Bordertown Mall Enclosed mall Roy Martin & Associates Ltd. Opened February, 1972	380,000	Woolco	N/A	34
3	North Park Shopping Plaza Strip center	115,000	Kroger Family Center	54,000	39
4	Palm Village Shopping Center Strip center Dorfman Development	60,245	None	N/A	18
	Total estimated 1977 inventory	1,205,245			

Retail supply in Plainville and Oakridge is limited to strip centers pending the planned opening of a regional mall in Plainville during 1983 or 1984.

Source: 1980 Shopping Center Directory/The South; JMB Realty Corp

Table 7

**Retail Sales Comparisons
Bordertown - Plainville - Oakridge
1974 - 1979**

	<u>Total Retail Sales</u>	<u>Food</u>	<u>General Merchandise</u>	<u>Furniture, Home Furnishings & Apparel</u>	<u>Automotive</u>	<u>Drug</u>
Douglas County						
1974	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
1979	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
Bordertown						
1974 % of County	49.27%	44.01%	57.03%	56.73%	47.59%	36.74%
1979 % of County	53.80	52.15	66.28	73.66	41.44	56.43
Plainville						
1974 % of County	36.48	35.90	40.88	34.53	41.51	39.80
1979 % of County	31.67	25.43	30.43	18.92	44.88	27.17
Oakridge						
1974 % of County	7.07	10.83	1.33	6.98	8.73	18.18
1979 % of County	6.56	11.66	0.89	4.27	9.57	11.23

Source: Sales & Marketing Management Annual Survey

Retail Demand

The Bordertown - Plainville - Oakridge SMSA has enjoyed substantial growth in retail sales as evidenced in Table 6 below.

Table 6

**Retail Sales Trends
Bordertown - Plainville - Oakridge SMSA
1972-1977**

	<u>1972</u>	<u>1977</u>	<u>Average Annual Increase</u>
Retail Stores	1,471	1,570	1.35%
Sales (\$000's)	\$302,185	\$533,375	15.30%
Payroll (\$000's)	\$33,229	\$62,853	17.83%
Paid Employees	8,239	10,680	5.93%

Source: U.S. Dept. of Commerce, Bureau of the Census, 1972 and 1977 editions of Major Retail Center statistics

In addition, the market share of the Bordertown area relative to the Plainville-Oakridge market has increased dramatically from 1974 to 1979 (Table 7), accentuating Bordertown's domination of the county's retail market. Whereas Bordertown represents approximately 42.48% of Douglas County's estimated 1979 population (Table 1), Bordertown's total retail sales during 1979 represented 53.80% of Douglas County's total retail sales. Even more striking are Bordertown's 66.28% share of general merchandise sales and 73.66% share of furniture, home furnishings, and apparel sales.

Retail Sales Potential

The retail sales potential of the Bordertown - Plainville - Oakridge SMSA can be measured by comparing retail sales of Department Store Type Merchandise (DSTM) to total personal income. As shown in Table 8, the percentage of per capita income spent on DSTM in Douglas County is 49.47%, which significantly exceeds a more typical ratio of 20% of per capita income expenditure for DSTM found in most metropolitan areas which have a more balanced inflow and outflow of retail expenditures.

Table 8

DSTM Sales as a Percent of Personal Income Bordertown - Plainville - Oakridge SMSA 1977

Total Retail Sales	\$540,121,000
Less:	
Building Materials, Hardware, Home Supply, Mobile Homes	(26,143,000)
Grocery Store Sales	(129,639,000)
Automotive Dealers	(90,492,000)
Gasoline Service Stations	(30,879,000)
Equals:	
DSTM Sales	\$262,968,000
1977 Population Douglas County	176,000
1977 Per Capita Income	3,020
Total Personal Income 1977, Douglas County	\$531,566,000
DSTM Sales as % of Income	49.47%
Typical DSTM Sales as % of Income	20.00%
Sources:	(1) 1977 Census of Retail Trade, Geographic Area Series, U.S. Department of Commerce; (2) 1977 Per Capita Money Income Estimates for States, Counties, and Incorporated Places in the South Region of the United States, Population Estimates and Projections, U.S. Dept. of Commerce.
Note:	Douglas County is conterminous with Bordertown - Plainville - Oakridge SMSA

The dominant effect of Bordertown's retail sales market position in the SMSA, and the effect of the Mexican population on retail sales, is measured when applying this same analysis to the city of Bordertown.

Table 9

**DSTM Sales as a Percent of Personal Income
Bordertown, Texas
1977**

Bordertown, Total Retail Sales	\$278,169,000
Less:	
Building Materials	(8,167,000)
Grocery Stores	(64,909,000)
Automotive Dealers	(38,752,000)
Gasoline Service Stations	(12,219,000)
DSTM Sales	\$154,122,000
1977 Population Bordertown	54,892
1977 Per Capita Income	2,796
Total Personal Income 1977, Bordertown	\$153,478,032

DSTM Sales as % of Income	100.42%
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- Sources: (1) 1977 Census of Retail Trade, Geographic Area Series, U.S. Dept. of Commerce
- (2) 1977 Per Capita Money Income Estimates for States, Counties, and Incorporated Places in the South Region of the United States, Population Estimates and Projections, U.S. Department of Commerce.

MARKET POTENTIAL, HORIZON MALL

In 1977, Bordertown had a total retail inventory of approximately 1.2 million square feet of gross leasable area (Table 5). With \$154.1 million of DSTM sales in Bordertown during 1977 (Table 10), the Bordertown market could have supported between 1.5 million and 2.1 million square feet of DSTM sales, assuming average sales performance between \$75 and \$100 per square foot (Table 10). Thus, the existing supply of retail space was in balance with consumer demand.

Based on the strong recent history of retail sales increases in the market area, and expected population and household growth in the area, there appears to be adequate support for the 420,000 square foot Horizon Mall. Even assuming some dilution of support due to the projected development of a new mall in the Plainville area, it is anticipated that sales volume and market rents will continue to grow at a healthy rate.

Table 10

**Supportable DSTM Space
Horizon Mall Primary Trade Area
1977**

1)	Primary Trade Area DSTM Sales (\$000's)	\$154,122
(2)	Supportable DSTM Space at \$75/sq. ft.	2,054,960
	at \$100/sq. ft.	1,541,220
(3)	Existing DSTM Space	1,205,245

- Notes:
- (1) Source: 1977 U.S. Census of Retail Trade, Geographic Area Series, U.S. Department of Commerce.
 - (2) Supportable retail or DSTM space is determined by applying industry standards of sales per square foot for DSTM space to DSTM sales estimates.
 - (3) From Table 5.

Source: JMB Realty Corporation

EMBARCADERO CENTER

A CASE STUDY

The Embarcadero Center, a five-block, 8.5-acre central city development, took 17 years to complete. This commercial element of a 51-acre "city within a city" redevelopment project required the cooperative efforts and combined creativeness of both the public and private sectors to make it work.

The Golden Gateway Redevelopment Project and its Embarcadero Center were certainly not an instant success. What was required was the transformation of a rundown section of the city, principally used as a produce market, to a vibrant, desirable addition in San Francisco that would connect the central business district with a potentially beautiful and functioning waterfront. This transformation required a vision by City officials for what its potential could be, the creativeness for producing a master plan for this vision, and persistence to stay with that plan until these goals were achieved.

Although this presentation deals primarily with the Embarcadero Center, its assessment with the entire Golden Gateway Redevelopment Project Area is important for a true understanding.

History

San Francisco was known originally as "Yerba Buena," and the land where Embarcadero Center now stands was among the first to see development activity. Early entrepreneurs sought to attract the lucrative world shipping trade to this potential port city.

This was not an easy task because tidal mud flats separated deep water from solid land. At about the same time (1847) that Yerba Buena became San Francisco, extremely long wharfs were constructed connecting deeper bay water with the shoreline. The first and longest wharf was located where the five blocks of Embarcadero Center are now located.

To accommodate the Gold Rush, shops, saloons, hotels, theaters, and warehouses lined these wharfs and were interconnected with a network of crosswalks.

However, the Gold Rush boom was shortlived; and as a result of abandoned ships, storms, neglect, and financial troubles, sections of the grid were abandoned and the tidal flats began to fill. This process evolved into a concentrated effort to fill these tidal flats, which culminated in construction of the current sea wall and permanent piers.

As with other parts of the downtown, the 1906 earthquake and resultant fire completely destroyed this area. Although the waterfront was rebuilt for commerce, by 1955 it was declared a blighted area, as it had become a congested, unsanitary, dilapidated produce market. The Board of Supervisors, San Francisco's governing body, took advantage of the then new Urban Renewal laws and created the Golden Gateway Redevelopment Project, one of the country's first. Goals for this area included:

- a. Cleaning up a blighted 51-acre area.
- b. Relocating the produce industry to a clean, efficient section of San Francisco.
- c. Allowing for expansion of the Central Business District.
- d. Increasing the city's tax base.

Redevelopment Process

The Redevelopment Agency (SFRDA), then under the leadership of M. Justin Herman, undertook one of the most ambitious redevelopment projects--the 51-acre, central city, mixed-use Golden Gateway. The concept was to create a mixed land use "city within a city." After lengthy economic, land planning, and urban design studies, it was decided that the Golden Gateway Project Area land uses would be principally housing, commercial, and park with sufficient amenities (i.e., shopping, restaurants, entertainment, parking) to support this section of the city.

With powers of eminent domain and purchase prices at fair market value, the SFRDA could acquire the many diverse

ownerships allowing for the full assemblage and subsequent disposition of land. The waterfront produce market was relocated to new, much more suitably located facilities in South San Francisco. All residential tenants and other businesses from the area were similarly relocated to other parts of the city which better accommodated their needs. Detailed planning and engineering design studies (followed by construction of all civil engineering works) were completed during the acquisition period so that the marketing of land could proceed immediately thereafter.

Marketing of the Golden Gateway Project Area was divided into three sections: The first and largest section was the Golden Gateway residential development. Second were the public improvements, including M. Justin Herman Plaza. The third, the Embarcadero Center, is the commercial section and is the focus of this presentation.

The SFRDA requested private proposals for the five city blocks which now comprise the Embarcadero Center. The selected submission was from a partnership composed of David Rockefeller, John Portman, Trammell Crow, and subsequently The Prudential Insurance Company of America, to sequentially develop the full 8.5 acres in a coordinated, multi-use project. The principal land uses were 2.7 million square feet of office, an 800-room hotel, 325,000 square feet of retail/restaurants/entertainment, and parking for 2,400 automobiles--incorporated into a village-like environment interconnected by aerial walkways between blocks.

Development Concept

On the three podium levels, although the Redevelopment Plan called for parking, the developer proposed to build three levels of shopping, restaurants, and entertainment and develop it in a manner to connect the existing central business district to the Golden Gateway residential section. The required parking was then placed underground at a considerable expense, allowing for a meaningful specialty shopping center.

The disposition agreement with the SFRDA required an orderly development start for each block so that office space absorption into San Francisco's office marketplace could take place over a 10-year period. The developer desired to construct the first development block closest to the existing business district. The SFRDA did not want a development with only one or two blocks and therefore

required the developer to construct the second building at the opposite end of the project--the Hyatt Regency Hotel. Construction starts for office blocks 2, 3, and 4 followed with a two-year cycle between buildings. Because of recession cycles during the development period, it was necessary to adjust the schedule to meet the city's overall market absorption rate.

Mortgage financing was acquired separately for each block of development. Except for the hotel and Two Embarcadero Center, which are combined, each block is a separate legal ownership entity, although all have the same participants.

Property management for the overall complex is by Embarcadero Center, Ltd., a company specifically established by David Rockefeller and John Portman to perform this function. The hotel, Embarcadero Center Five, was also developed by the Embarcadero Center Partnership and is managed by contractual agreement by the Hyatt Corporation.

As might be expected in pioneering a new, unique development concept, the project was not an immediate success. The Embarcadero Center had to compete for tenants in the overall San Francisco marketplace. Many of its competitors were positioned in well-established San Francisco locations. However, as time proceeded and the Embarcadero Center concept was understood, the project became popular and today is one of San Francisco's most prestigious addresses and provides approximately 10% of San Francisco's Class A office space.

Retail, likewise, had its shaky beginnings. It was not until the third block of development was completed that there was a sufficient number of shops, restaurants, and entertainment facilities to provide alternative choices which contributed to the center's success. Today, it is one of the Bay Area's most successful shopping centers, when compared to all types of shopping enclaves.

The Design

Private real estate development has as its principal goal economic success. The Embarcadero Center incorporates this idea. In addition, it is architect John Portman's concept that it is also the developer's responsibility to make a contribution to society. This is doubly true in the case of land acquired through the redevelopment process.

This idea has been accomplished by creating an environment for people. The principal element of the concept is the creation of a place where there is a refuge from vehicular traffic, congestion, and noise. Separation between the public arena and the private space is also provided by a three-level area which contains shopping, restaurants, entertainment, and landscaped open space which extends throughout the five development blocks. The private space is located in highrise towers above the three-level podium structure. Service and parking are located in several levels below grade.

A major pedestrian street along the Commercial Street corridor provides the primary interior circulation element. Off of this street are located escalators and stairs for vertical circulation. The office tower lobbies are located at the lobby (or second) level, causing their tenants to circulate up from the street level or down from the podium level.

The Embarcadero Center complex is essentially designed as a single building which, with each individual structure having a relationship with the whole, provides a commonality of materials, colors, forms, and textures. Each element is in context with the whole. Landscaping, fountains, pools, and major works of art contribute to the integration of the whole, forming a high-quality environment.

Although the overall density of development is very high, there is a feeling of space and tranquillity which is rarely achieved in the midst of today's high-density cities.

The success of the design has contributed much to the city of San Francisco for all to enjoy, whether tenant or visitor to the complex. This in turn has led to the financial success of Embarcadero Center, measured by high rental rates and sustained high occupancy levels.

Expansion of Embarcadero Center

In the early 1980s while completing construction of a new facility in San Francisco, the United States Federal Reserve Bank decided to offer the old Federal Reserve Building and land for sale. The property afforded a logical expansion of Embarcadero Center to the west. In July of 1982, the Federal Reserve selected a proposal by the Embarcadero Center ownership, which included preserving, restoring, and landmarking the old Federal Reserve Building.

The three-parcel acquisition with a land area of 1.6 acres allows continuation of the Embarcadero Center's development concept. The continuation of the central circulation spine along Commercial Street will provide pedestrian circulation into the expansion area by bridging Battery Street. A decorative landscaped stair ramp brings the pedestrian to street level and continues the Commercial Street pedestrian way from the Ferry Building one more block toward Chinatown's Grant Avenue.

This phase's centerpiece will be the landmarked Federal Reserve Building, which will provide 130,000 square feet of office space, while the banking hall and basement level will become a 35,000-square-foot food and entertainment center.

Opposite the Federal Reserve to the north will be a 360-room Park Hyatt Hotel, designed to fit the Embarcadero Center family of buildings. Both the hotel and the Federal Reserve's public areas are linked to the pedestrian bridge system.

Across Sacramento Street is located a 435,000-square-foot office tower of distinctive design compatible with the existing office towers. A rich base of granite is connected to a crenellated top by a curtain wall similar to the other Embarcadero Center office towers.

Just as the Hyatt Regency with its unique atrium, the parkway, M. Justin Herman Plaza, and the retail assemblage of Embarcadero Center Four create a major urban place, so will the Federal Reserve, Park Hyatt, and Commercial Street provide a similar setting on Embarcadero Center's west end.

Conclusion

From the City's standpoint, the 51-acre blighted area has been transformed into a meaningful and productive part of the city. The produce industry was relocated to new, clean, efficient facilities. From a very low tax base, the Embarcadero Center now contributes annually in excess of \$12 million combined taxes. The central business district has expanded in a manner causing little if any negative environmental impact. Not only does the Embarcadero Center maintain the Justin Herman Plaza, it has provided in excess of 10 acres of privately owned, publicly used space on three levels throughout the complex. It is estimated that the daytime population of workers and visitors to Embarcadero Center is in excess of 12,000.

From the developer/owner's standpoint, an economically viable real estate development has been completed and is now in the process of being expanded. Substantial risk capital was required; however, through creative efforts it has been possible to create a central city complex that has long-term investment benefits and provides satisfaction to the ownership in making a truly remarkable contribution to San Francisco's urban society.

F A C T S H E E T

E M B A R C A D E R O C E N T E R

Nature of Development

"City within a city" complex including office, commercial, hotel, shopping, entertainment, and parking facilities. A major hotel and four office towers, each with three inter-connecting shopping levels. The entire project celebrated its completion in May of 1982.

Owners and Developers

The joint venture is composed of:

The Prudential Insurance Company of America
and Affiliates
David Rockefeller and Associates
John C. Portman, Jr., FAIA

Project Manager

Embarcadero Center, Ltd.

Location

Assessor's Blocks 230, 231, 232, 233, and 234, San Francisco, California. Bounded by Clay, Battery, Sacramento, Drumm, California, and Market streets and by M. Justin Herman Plaza and the Hyatt Regency San Francisco Hotel.

Land Area

8.5 acres, or approximately 370,000 square feet. Parcel is part of the 51-acre Golden Gateway Redevelopment Area.

Jurisdictional Public Agency

San Francisco Redevelopment Agency.

Developed Space

Over 2.75 million square feet of office space, approximately 325,000 square feet of retail space, 804-room hotel, 2,400 underground parking spaces, and over 200,000 square feet of landscaped public area.

Architect and Master Planner

John Portman & Associates, Architects and Engineers

Special Features

Five-block, 325,000-square-foot shopping area of more than 175 stores, restaurants, shops, and boutiques on three levels, connected by pedestrian bridges above the streets.

Particularly noteworthy artworks throughout the public areas of the development include major works of sculpture by Willi Gutmann, Nicolas Schoffer, Charles Perry, Barbara Shawcroft, Lia Cook, Louise Nevelson, and Jean Dubuffet. Embarcadero Center's investments in public artwork and landscaped area exceed \$5 million.

Underground parking for 2,400 cars.

Extensively landscaped open space, connected by pedestrian bridges to the multimillion-dollar residential/office/commercial Golden Gateway Center.

20-story Hyatt Regency San Francisco Hotel with its spectacular 17-story atrium lobby.

An outdoor theater with seating for 250 people located in Justin Herman Plaza adjacent to Four Embarcadero Center.

Awards

Ninth Annual Esquire Magazine/BCA Award, 1974
Urban Renewal Program, Sixth Biennial HUD Design Award,
1974
Urban Land Institute's 1984 Award for Excellence,
Large-Scale Development
1985 San Francisco Chamber of Commerce Business/Arts Award

Investment

Estimated total development cost of \$375,000,000.

Economic Impact/Employment Data (Approximate)

Total population of center	15,000
Current annual employment payroll for center population	\$500 million
Total current annual taxes (payroll, sales, property)	\$18 million

Development Timetable

Phase 1 One Embarcadero Center

Security Pacific Bank Building. 45-story office building with three-level shopping gallery.

Groundbreaking	July 1968
Completed	March 1971

Phase 2 Five Embarcadero Center

20-story Hyatt Regency San Francisco Hotel.

Groundbreaking	March 1971
Completed	May 1973

Phase 3 Two Embarcadero Center

35-story office building with three-level shopping gallery.

Groundbreaking	March 1972
Completed	April 1974

Phase 4 Three Embarcadero Center

35-story office building with three-level shopping gallery.

Groundbreaking	April 1974
Completed	September 1976

Phase 5 Four Embarcadero Center

45-story office building with three-level shopping gallery.

Groundbreaking	January 1978
Completed	May 1981

Building Areas by Use

	<u>Assessor's Block #</u>	<u>Stories</u>	<u>Net Rentable Square Feet</u>
One Embarcadero Center:			
Office Tower	230	40	691,000
Retail		3 levels	78,500
Other		2 levels	---
Two Embarcadero Center:			
Office Tower	231	30	650,000
Retail		3 levels	75,000
Other		2 levels	---
Three Embarcadero Center:			
Office Tower	232	30	648,000
Retail		3 levels	76,000
Other		2 levels	---
Four Embarcadero Center:			
Office Tower	233	40	759,000
Retail		3 levels	95,000
Other		2 levels	---
Five Embarcadero Center (Hyatt Regency Hotel)			
804 rooms	234	20	

E M B A R C A D E R O C E N T E R W E S T

An expansion to the west of the Existing Embarcadero Center complex with a construction start scheduled for fall of 1986.

Nature of Development

Embarcadero Center West is a three-block, mixed-use development which features a new 24-story, 360-room hotel, a new 33-story office building and, as its centerpiece, a prominent national and city historical landmark, the nine-story original Federal Reserve Bank building of San Francisco, preserved and handsomely restored for public and commercial use. This development will be linked to the existing Embarcadero Center by a pedestrian bridge over Battery Street leading to a pedestrian ramp onto Commercial Street.

Owner

The joint venture is composed of:

The Prudential Insurance Company of America
David Rockefeller and Associates
John C. Portman, Jr., and Affiliates

Development Manager

Embarcadero Center, Ltd.

Architect and Master Planner

John Portman & Associates, Architects and Engineers

Location of Development

In the San Francisco central business district, the Embarcadero Center West project site includes three parcels of property bounded by Battery, Clay, Sansome, and Halleck streets in San Francisco, California.

Parcel 1 (Hotel)	Block 229, Lot 20
Parcel 2 (Former Federal Reserve Bank)	Block 229, Lot 3
Parcel 3 (Office)	Block 238, Lots 1 and 7

Land Area

Approximately 71,100 square feet, or 1.6 acres.

Jurisdictional Public Agency

City and County of San Francisco, City Planning Commission.

Developed Areas

Parcel 1	Approximately 285,000 square feet of hotel space, including 360 hotel rooms, restaurant, meeting rooms, and public open space.
Parcel 2	Approximately 140,000 gross square feet of office space and 50,500 gross square feet of restaurant and retail facilities within the renovated historical space.
Parcel 3	Approximately 480,000 gross square feet of office space, including below-ground parking with retail and public open space at street level.

Project Features

This development will be linked to the existing Embarcadero Center by a pedestrian bridge over Battery Street, where it will connect to a pedestrian ramp leading into the retail, hotel, and pedestrian activities on Commercial Street and the renovated former Federal Reserve Bank building. As a continuation of the pedestrian activities on Commercial Street from Justin Herman Plaza to Battery Street, Commercial Street from Battery to Sansome will be closed to vehicular access. Approximately 19,000 square feet of publicly accessible open space will be incorporated into this development. Additionally, the project sponsor is studying the feasibility of providing an on-site day care facility for workers and employees of the Embarcadero Center area.

Parcel 1 Features (Hotel):

- 24 stories above ground, three below
- Approximately 360 guest rooms
- Gross floor area approximately 285,000
- Auto entrance off Clay Street, pedestrian entrances off Clay and Battery streets
- Distinctive, Hyatt Regency-related architecture
- First three levels containing hotel activities, meeting rooms, restaurant, lounge, and public terrace
- Some guest rooms to include balconies or bay windows
- Hotel integrated with retail activities of the renovated former Federal Reserve Bank and also existing Embarcadero Center, providing an exciting western complement for the Embarcadero Center

Parcel 2 Features (Former Federal Reserve Bank):

- Building first constructed in 1923, with several subsequent additions
- Architect was the prominent George W. Kelham
- Total former Federal Reserve Bank property (ECW site) put up at public bid in 1982
- Renovation to include 140,000 gross square feet of first-class office space on the upper six floors
- Lower levels to include proposed food center and related retail
- Building one of the first of its kind to be completely seismically upgraded per current building codes
- New grand portico to be added at the east end in keeping with the people-oriented atmosphere of Embarcadero Center
- Building is eligible for the National Register of Historic Places

Parcel 3 Features (Office):

- 33 stories above ground, three below
- Approximately 480,000 gross square feet of office and retail space
- Retail space and open space at ground level
- Stunning, Downtown Plan-style architecture

Investment

Estimated total development cost: \$270 million

Economic Impact/Employment Data

Projected net new permanent Bay Area jobs	12,400
Housing obligation fulfilled by sponsor	352 units
Projected annual revenues to the City	\$5 million
Transit impact fee to be paid by sponsor	Approximately \$2 million

Development Timetable

Parcel 1 (Hotel):

Projected construction commencement	May 1, 1986
Completion of construction	June 1, 1988

Parcel 2 (Former Federal Reserve Bank):

Projected construction commencement	June 1, 1986
Completion of construction	January 1, 1988

Parcel 3 (Office):

Projected construction commencement	May 1, 1986
Completion of construction	June 1, 1988

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CASE STUDY

Submitted By: JMB REALTY CORPORATION

February 11, 1986

LATE NEWS FLASH!!

January 20, 1986

Since this case was prepared, Colonel Khadafy has been causing trouble in the Mediterranean, and Libyan assets have been frozen in the U.S.A. Several Italian oil companies had been intending to pursue joint ventures with Libyan oil companies but now have decided to pursue joint ventures with a couple of Atlanta-based firms; consequently the Atlanta office market has tightened up. New leases have been signed which will increase the buildings cash flow by \$500,000 per annum beginning in 1986 and extending over the next five to seven years. Furthermore, options under these leases, if exercised, could provide an additional \$1,000,000 p.a. for the building's cash flow after 1995. As a result of these changes, Carlotta feels more positive in underwriting a higher residual.

Meanwhile, in Los Angeles the 40,000 square foot potential tenant (proposal 2) turned out to be expansion space for a Libyan investment fund which invested Libyan assets in U.S. banks. Since the Libyans have had their assets frozen, this deal is now dead. The remaining proposal has been accepted and the building will soon be 72% occupied, rather than 80%, as had been previously hoped. Furthermore, the "worst-case" lease-up is now feared to last until June 30, 1989, and the downside risk to JMBDIP has been increased by \$2 million to a total additional exposure of \$4 million.

This additional information should be taken into account when you answer the questions posed in the case.

CASE

Nathaniel P. Vance opened the door to his new office at JMB Realty Corporation's headquarters on the 39th floor of the John Hancock Building in Chicago. The corner of his mouth slowly turned upward into a small smile as he surveyed the expansive room. Tastefully decorated with emphasis on grey flannel and walnut cabinetry, the office offered a magnificent view of both the Lake Michigan coast and the Chicago skyline. Taking a seat at his desk, Nate stroked the rich, Corinthian leather on the chair's well-proportioned armrests. His small smile suddenly turned into a broad grin as he thought to himself: "Hm, this new office is not too bad. I guess it was worth the five tough years of dealmaking. Plus, with my new promotion to Acquisitions Investment Committee Member (or "Godfather" for short), I've got a lot more responsibility." As Godfather, Nate would not only be overseeing five dealmakers but also be serving on the Investment Committee, the five-person group which decides on all property investments made for JMB's publicly sponsored Limited Partnerships.

Nate picked up the pile of mail that lay opened and neatly stacked in his leather-lined letter tray. His new administrative assistant had stacked the mail in order of its importance, starting with his Mileage Plus Update from United Airlines. (Nate has been accumulating miles for the ultimate prize: a two-week excursion to Tahiti with the United flight attendant of his choice; his new account balance showed him just 20,000 miles from his goal.)

©. 1985, by JMB Realty Corporation. All facts have been modified. All names are fictitious and are not intended to represent any actual joint venture partner of JMB.

Next in the pile was a manila folder holding three Investment Memorandums that described potential deals that the Investment Committee would review at its next meeting. These memos had been prepared in great detail by JMB critics: the selfless, hard-working, aggressive recent business school graduates who assist the dealmaker in market and economic analyses of potential investments. Investment Memorandums summarize all the salient information necessary in analyzing an investment and are the bases for discussion in Investment Committee meetings. Nate remembered his days as a critic; they were heady times marked by red-eye flights, romantic encounters in overbuilt markets, and slide-rule number crunching.

But with his days as critic and then dealmaker now over, Nate had the luxury to find deals neatly packaged in Investment Memos in his letter tray. Nate's smug smile, which had returned as he reveled once again in his new status, disappeared quickly as he began to leaf through the three memos. "My God!" he thought, "there is no 'slam dunk' amongst these three. This Godfather business might not be as easy as I had thought."

Nate read on. One deal, a major office building in downtown Los Angeles, was only partially leased (albeit to a very high credit tenant) and faced a potentially tough leaseup period. Another, an office/R & D project in suburban San Diego, was fully leased but faced problems in the future. The third, a sparkling jewel of a building, in a secondary location in an otherwise vibrant suburban submarket of Atlanta, provided fixed, above-market master lease payments for 15 years.

Nate read each of the Investment Memos in great detail because he knew that he would be called upon today at his first Investment Committee meeting to prioritize the potential of each deal and substantiate his opinion for the order he picked. While he had clearly demonstrated his ability as dealmaker

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-- his promotion was evidence of that -- he would now be the rookie Godfather and would thus be scrutinized on his first few decisions.

"At first glance," Nate thought, "I wouldn't do any of these deals. At the same time, I know that almost all real estate markets are extremely tough today, and we can't just close up shop." Nate, of course, understood that investors' continued interest in real estate meant that it was the responsibility of JMB's acquisition department to find the best opportunities available and structure around any potential problems.

All three of these properties were potential investments for the same public limited partnership: JMB Diversified Investment Properties-MCMLXXXVI (JMBDIP-MCMLXXXVI). Each of these investments was the appropriate size for the fund. An investment in any of them would commit enough dollars in this fund so that JMBDIP-MCMLXXXVII could go "effective," or start raising funds. In addition, investments made to date in JMBDIP-MCMLXXXVI had been mostly in shopping centers and a few office projects in the South and Midwest. An investment in an office building or R & D project on the East or West Coast would enhance the diversification, by location and property type. (See Exhibit A for the investment objectives and policies of JMBDIP-MCMLXXXVI).

At this point, Nate went with his instincts and thought back to those lonely nights near closing time at La Terrasse, where one often looked for "deals", but was rarely satisfied with the available opportunities. Nate, turning to his old reliable "confidence builder", opened the bottom drawer to his desk, pulled out a bottle of Glenfiddich, and poured himself a shot (or two) of scotch as he began to weigh the three alternatives and prepare his comments for the Investment Committee meeting that afternoon . . .

Assignment:

As an Acquisitions Godfather, Nate is an integral part of the decision-making process for all investments made by JMB's publicly offered funds. Decisions by the Investment Committee are made on a consensus basis, as opposed to a majority rule. Therefore, it is extremely important that Nate's reasoning be well developed for discussion with other members of the Committee. Decisions are an easy and natural outgrowth of these discussions.

Imagine that you are in Nate's position. You should analyze each of the attached Investment Memorandums, focusing especially (but not exclusively) on the following areas:

- 1) Quality of project
- 2) Location
- 3) Leasing status
- 4) Market factors (both short-term and long-term)
- 5) Credit (of tenants, of developer)
- 6) Upside potential
- 7) Downside risks
- 8) Deal structure
- 9) Numerical analysis
- 10) Potential to restructure deal (if necessary)
- 11) Likelihood of closing deal

Rank each of the deals in the order in which you would advise doing them.

Instead of making yes/no decisions on each property, you should concentrate

more on the substantiation of your ranking. Adequate reasons should be provided for both why you would and would not do each of the deals. Be sure to consider possible changes to deal structures that may help to overcome your concerns about the specific deals. (What is the likelihood that the seller will accept your changes?)

Notes to the student: The buildings described in this case are composites of a number of different properties in diverse locations. It will be fruitless for you to try to identify these buildings; identification of a similar property will be of no benefit in analyzing the deals. All pertinent information necessary for preparing your analysis is provided for you herein.

The numerical analysis provided has been presented in a simplified form and should be accepted largely as fact. A Godfather would not crunch 10-year projections himself, but would rely on the analysis provided by the critic. Ten and fifteen-year analyses have been excluded from the presentations. Try to draw conclusions based on your "gut" reading of the facts. Do not hide behind numerical analysis, but evaluate the real estate, the risk, and the deal structure.

A Godfather often uses simple "rules of thumb" to compare deals in a "short-hand" analytical way. Similarly, your emphasis should be on the issues involved in evaluating real estate portfolio decisions. You might, however, consider (perhaps in your analysis of upside/downside) changes to the stabilized pro-formas shown for each deal. You may find it useful to look at effective rents (face rents discounted for concessions) to underwrite the upside potential for each deal.

Limit yourself to a pre-tax analysis, ignoring the tax benefits of the investments. Also, analyze each property on a free and clear, unleveraged basis. (Ignore the differences or benefits of the first mortgage financings.) Assume each property, upon full lease-up, meets the near-term cash flow objectives.

EXHIBIT A

INVESTMENT OBJECTIVES

The investment objectives of JMB Diversified Investment Properties-MCMLXXXVI are to provide Limited Partners:

- Current cash distributions (low in yrs. 1-3; increasing thereafter);
- Capital appreciation through the increase in the value of the properties.

Anticipated funds available for acquisitions: \$300,000,000

Anticipated leverage: Between 60 and 67% of purchase price.

INVESTMENT POLICY

JMB Diversified Investment Properties-MCMLXXXVI will invest in a diversified portfolio of income-producing real properties consisting primarily of recently completed commercial properties, such as shopping centers, office buildings and high quality industrial projects. These properties will be located in various cities throughout the United States.

It is anticipated that the Partnership will use borrowed funds (leverage) in connection with the purchase of some of the properties. The overall objective of the fund is to achieve 2:1 leverage (67% of economic value in the form of debt). The anticipated leverage in each deal presented will be acceptable to the fund.

The Partnership intends to hold the properties it acquires until sale or disposition appears to be most advantageous from the viewpoint of the Partnership and its investment objectives. It is presently intended that the properties will be sold or refinanced between the 5th and 12th years after acquisition, and the Partnership will seek to sell properties so that the average holding period for properties is between 7 and 8 years. However, the Partnership is not obligated to sell properties at any particular time.

The Partnership is self-liquidating in nature and no reinvestment of sale or refinancing proceeds in additional properties is permitted.

Note:

(1) Each of the three deals represents less than 10 percent of the total investible funds of JMBDIP-MCMLXXXVI. To date, \$250 million has been invested; as a policy, the next fund cannot be sold to the public until the prior fund is 90 percent specified. Any of the three deals will allow JMB to market the next fund to the public.

(2) If the committee so elected, all three deals could be pursued.

INVESTMENT MEMORANDUM
THE COLOSSUS CORPORATION TOWER
LOS ANGELES, CALIFORNIA

**THE COLOSSUS CORPORATION TOWER
LOS ANGELES, CALIFORNIA
INVESTMENT MEMORANDUM**

PROPERTY DESCRIPTION

The Colossus Corporation Tower (the Project), completed in 1984, contains approximately 500,000 net rentable square feet of space. The Project was developed by Colby Enterprises, a major developer of office properties in the Los Angeles/Southern California area. The structure encompasses 24 floors and is extremely well located in downtown Los Angeles, California. The Colossus Corp Tower is generally recognized as "the place to be" in downtown Los Angeles.

Colossus Corp. leases 250,000 square feet (approximately 50% of net rentable area) which includes some of the first floor and all floors from the mezzanine through the 12th floor. The building's lobby is housed in a two-story glass enclosed pavilion called King's Court Pavilion, which provides restaurants, retail and public spaces for tenants and outside customers.

The Project has the capacity to park 750 on-site vehicles (380 leased to Colossus), a good parking ratio for a downtown LA office building.

The Colossus Corp. Tower is situated on the north side of 4th Street extending the full block between Hope Avenue and Pray Street. It is in Los Angeles' prestigious Bunker Hill area and is close to the center of downtown Los Angeles. The location of The Colossus Corp. Tower is generally recognized as the premier office location in downtown Los Angeles, with great potential for long-term growth in demand and asset value.

The Colossus Corp. Tower is of steel frame construction with lightweight concrete floors and is supported on spread footings and drilled-and-belled caissons. An exterior wall system of polished Cornelius marble cladding and aluminum window wall with insulating solar bronze reflective glass effectively delivers visual impact and creates an air of prestige and refinement. The off-site parking structure consists of two levels above grade and one level below grade and is constructed utilizing concrete slabs, beams and columns.

THE COLOSSUS CORP. TOWER
INVESTMENT MEMORANDUM
Page Two

MARKET ANALYSIS

The downtown Los Angeles office market is currently in somewhat of a shambles from a landlord's perspective. There are approximately 2.0 million square feet available to lease in buildings competitive with The Colossus Corp. Tower. Furthermore, an additional 3.8 million square feet of competitive space are expected to be completed between the end of 1987 and early 1988. Annual absorption in downtown Los Angeles has averaged approximately 1.2 million square feet per year for the last five years, which indicates that the current softness in the market may firm over the next two years, but quickly return by 1987 and continue for three to four years. Nevertheless, the long-term prospects for the market are excellent. The Bunker Hill area in particular should be in high demand once the oversupply has worked itself out of the market.

LEASING STATUS

Currently, The Colossus Corp. Tower is 60% leased to two tenants. While it was clearly a coup to land the Colossus Corp. deal 18 months ago, before the market turned soft (and at rates \$5 per square foot above the current market of \$23 per square foot net), Colossus was able to negotiate a 25% equity stake in the building as part of the deal. The remaining 10% of space that has been leased (50,000 square feet) represents the only lease signed in the year since opening, which is a further indication of the softness of the market. The developer, Colby Enterprises, claims that they consciously avoided leasing in the difficult market of 1984 and early 1985. With many tenants now "in the market", Colby Enterprises feels they can get their share of tenants and lease the project quickly.

It is hoped that the building will be 95% leased as of January 1, 1988, but in the worst case, the building is expected to be 95% leased and paying rent as of January 1, 1989. There are currently two major deals pending that have been proposed to tenants; if signed, these deals would bring the building to 80% occupancy as of June 1, 1986. Colby Enterprises is confident that they can do both deals, but JMBDIP is not as confident.

While leasing has progressed slowly since leasing half of the building to Colossus, it is expected that because of its quality and location that ultimately the Colossus Corp. Tower will be leased to credit tenants, primarily law, international trading, and consulting firms. The question is one of cost: How much will it cost to fill up this project in the currently tough market.

DESCRIPTION OF FINANCIAL DEAL

The Colossus Corp. Tower is currently owned by a partnership which is comprised of Colossus (25%), and the developer, Colby Enterprises (75%). Colossus has indicated that they are not interested in selling any portion of their position at any price whatsoever. The property is currently subject to a \$100 million first mortgage loan at a 10.5% interest rate, with interest only payments throughout the life of the 12-year loan. The property is currently managed by Colby Enterprises Managers, a subsidiary of the developer, for a fee equal to 3% of gross receipts.

The partners have experienced a disappointing negative cash flow due to the weakness in the Los Angeles office market (approximately 60% of the Colby Enterprises portfolio is located in Los Angeles). Additionally, Colby Enterprises recently committed to begin a new 1 million square foot office building as soon as the Colossus Corp. Tower is 90% leased (this new building is included in the 3.8M new development number). In an effort to increase their liquidity, Colby Enterprises has actively been seeking partners in its Los Angeles buildings.

About three months ago, Colby Enterprises approached JMB with the intent of selling two-thirds of its 75% ownership position in The Colossus Corp. Tower to raise cash to help fund anticipated deficits in this property. Colby Enterprises indicated that they believed in the market in a long-term sense, and that they wished to remain a partner in the building to share in expected appreciation; the fact that they wanted to remain a partner in the building confirmed JMB's thoughts about the ultimate strength of the market and this building.

Current Deal Between Colby Enterprises and Colossus Corp.

Cash Flow:

- No preferences
- All available proceeds split 75/25 between Colby Enterprises and Colossus Corp. respectively
- Any fill up obligations (operating deficits) shared 75/25.

DESCRIPTION OF FINANCIAL DEAL (continued)

- Refinancing or Sale: - No preferences
 - All available proceeds (after
 repayment of debt) split 75/25
 between Colby Enterprises and
 Colossus Corp. respectively

Colby Enterprises approached JMB with a desire to sell a 50 percent interest in the building, with no preferences on cash flow and sales proceeds.

Proposed Transaction

The proposed deal contemplates that JMBDIP will acquire a 50% interest in the asset by acquiring 2/3 of Colby Enterprises' interest for \$30 million. The current deal, as shown above, will stay intact, and JMBDIP's share of cash flow and sale proceeds will be paid out of Colby Enterprises' 75 percent share of available benefits. The following describes how the 75 percent partnership between JMBDIP and Colby Enterprises will share the benefits between them:

Cash Flow (of 75% to JMBDIP/Colby Partnership):

- JMBDIP gets Guaranteed Returns of 6%, 7%, 8%, and 8% for 1986, 1987, 1988, and 1989. Any excess cash flow goes to Colby.
- After 1989, JMBDIP gets an 8% cumulative preference with all excess cash flow split 2/3:1/3.

Refinance or Sale (Of 75% to JMBDIP/Colby Partnership):

- 1) Any contributions for excess operating deficits repaid to contributing partner.
- 2) JMBDIP gets the first \$60 million.
- 3) All excess proceeds split 2/3:1/3.

DESCRIPTION OF FINANCIAL DEAL (continued):

Operating Deficits:

This is the only area that has been revised from the current Colossus/Colby partnership structure. Under the revised structure, the partners will contribute the following:

	<u>%</u>	<u>Amount</u>	<u>Additional</u> <u>%</u>
JMBDIP	--	--	50%
Colby	75%	\$12 million (A)	25%
Colossus	25%	<u>\$ 4 million</u>	25%
		<u>\$16 million</u>	

(A) Paid from JMBDIP's \$30 million purchase of its 50% interest.

The \$16 million deficit reserve fund will be established upon the admission of JMBDIP as a partner in the deal. If operating deficits exceed \$16 million, each partner will be responsible for its pro-rata share of deficits. If the full \$16 million is not used, the partners will split the remaining proceeds pro-rata. JMBDIP has assumed no capital will be distributed to the partners.

JMBDIP's internal downside analysis shows a potential additional investment of \$2 million (50% of \$4M excess deficits over \$16 million). In evaluating JMBDIP's return on investment, this potential downside must be factored into a review of the pricing. This aspect of the deal has been highly negotiated, and though it is unusual, JMBDIP has agreed to accept this risk.

Additionally, JMB's guaranteed return will be fully secured by a letter of credit (through 1988).

In evaluating the pricing of this deal, JMB feels that due to the significant preferences on Colby's position in the deal, JMBDIP's \$30 million of equity has acquired approximately 65%

THE COLOSSUS CORP. TOWER
INVESTMENT MEMORANDUM
Page Six

DESCRIPTION OF FINANCIAL DEAL (continued)

of the asset (JMBDIP owns only 50% of the ultimate upside, but has significant preferences). Therefore, the asset price for JMBDIP's interest is:

JMBDIP Equity:	\$30 million
"True" JMBDIP Ownership Position:	65% (Colossus: 25%; Colby: 10%)
Imputed Equity Value:	\$46.15 million (\$30M div. by 65%)
Add: Debt	<u>\$100 million</u>
Asset Value:	\$146.15 million
Asset Square Feet:	500,000
Price/Foot	<u>\$292/sq.ft.</u>

Though this is a high price per square foot, other buildings in downtown Los Angeles have traded at or near this price in the last six months. The price per foot would be even higher (over \$300 per square foot) if the "downside" fill up operating deficits are realized. There is no assurance that JMBDIP's fill-up obligations will be limited to the additional \$2 million.

The most critical factor in evaluating the price/foot is to compare this price to the effective rent per square foot (i.e., discounting the "face" gross rent to factor in the above-standard concessions). The attached market study discusses this aspect of the deal and the attached rent roll outlines the current and contemplated concessions necessary to lease the property.

THE COLOSSUS CORP. TOWER
INVESTMENT MEMORANDUM
Page Seven

STABILIZED PROFORMA (1988) (000's)

Gross Rents (C)

Colossus (250 sf @ \$35/sf)	\$ 8,750	
MF&P (50,000 sf @ \$30/sf)	1,500	
Proposal 1 (60,000 sf @ \$29/sf)	1,740	
Proposal 2 (40,000 sf @ \$30/sf)	1,200	
Spec. Space (100,000 sf @ \$31/sf)	3,100 (A)	
Total Gross	16,290	
Less: 5% (non-Colossus) vacancy	(377)	
Effective Gross		15,913
Parking Income		1,544 (B)
Total Income		17,457
Less: Expenses (500,000 sf @ \$7.50 sf)		(3,750)
Net Operating Income		\$13,707
Less: Debt Service		(10,500)
Anticipated NCF		3,207
25% to Colossus		(802)
Available to Colby and JMBDIP		2,405
JMBDIP 8% Return		(2,400)
Available to be split 75/25		5

(A) Includes top 2 floors in building

(B) 750 stalls @ \$120/month (+6%, 3 yrs.) @ 120% oversell.

(C) Gross rents are actual (and/or anticipated) face rents, no discounting of rents has been included to factor in concessions

CRITIC SUMMARY

Strengths:

- Excellent long-term potential arising from superb location, high quality construction, and high-credit, long-term lead tenant.
- Lead tenant also an owner; therefore, not likely to move when lease expires in 1998.
- Some renewed leasing activity seen in the market lately. This is reflected in the expanding "prospect list" of tenants.
- Above average parking for a downtown L.A. Building.
- Opportunity to do deal with Colby, a good source for future deals.
- Downtown market mostly 10-15 year leases, with "bumps" (increases in rent) in 6th and 11th year; therefore, little rollover risk.

Weaknesses:

- Heavy concessions to tenants makes pricing analysis difficult.
- High price per foot, could be a marketing issue.
- Possibility that Operating Deficit Reserve is insufficient; JMBDIP has unlimited downside risk related to fillup.
- Extremely soft office market at present.
- Possible heavy criticism from underwriters for sharing in lease-up risk.
- Colby has questionable ability to put its share of deficits if significant additional funds are required.

THE LOS ANGELES REGION

Los Angeles is the second largest Metropolitan Statistical Area (MSA) in the United States. It has consistently been one of the fastest growing of the nation's major population centers. The Los Angeles area's 1980-1984 growth rate of 7.6% almost doubled the combined increases of New York, Chicago and Philadelphia, the country's first, third and fourth largest metro areas respectively. Of the ten largest metropolitan areas in the United States, only Dallas and Houston experienced higher rates of growth. Growth in the Los Angeles area appears to be accelerating, with recent rates of employment and population expansion both up over previous years.

1980 - 1984
POPULATION TRENDS
TEN LARGEST METRO AREAS IN U.S.

<u>Metropolitan Population Ranking</u>	<u>Statistical Area</u>	<u>1984 Population</u>	<u>% Change Since 1980</u>
1	New York	17,807,800	1.5%
2	Los Angeles	12,372,600	7.6%
3	Chicago	8,034,900	1.2%
4	Philadelphia	5,755,400	1.3%
5	San Francisco	5,684,500	5.9%
6	Detroit	4,577,700	(3.7%)
7	Boston	4,026,500	1.4%
8	Houston	3,565,100	15.0%
9	Washington D.C.	3,429,400	5.5%
10	Dallas	3,348,100	14.2%

Source: U.S. Bureau of Census; Department of Commerce.

Los Angeles is one of the strongest, most dynamic business centers in the world. It has a broad based, diversified economy that has made it only mildly subject to cyclical swings in the national economy. The Los Angeles region leads the nation in manufacturing jobs, with many of these in aerospace, electronics and other high-growth industries. Los Angeles is also a major national and international distribution center, an important financial center, and a primary gateway to the Far East. Twenty-three Fortune 500 companies have their headquarters in the Los Angeles metro area.

THE COLOSSUS CORP. TOWER
INVESTMENT MEMORANDUM
Page Ten

An area of the local economy that has demonstrated particularly strong growth in recent years is the finance and business services sector. Expansion of this segment of white-collar employment has stimulated strong office demand through the Los Angeles area.

DOWNTOWN LOS ANGELES

Los Angeles has emerged as the focal point for this country's business relationships with the Pacific Basin countries including Japan, Hong Kong, Taiwan, Korea, Singapore and China. The port of Los Angeles is now the second largest port complex in the United States behind New York, and accommodates two-thirds of the foreign port tonnage coming from the Far East.

As the center of this vital link to the Orient, downtown Los Angeles has experienced major real estate development activity over the past five years. New projects continue to flourish with growth accelerating in all categories of office, retail, housing, hotel and restaurant development. The downtown has been transformed into a major world business and financial center. The money center banks, like Chase, Citicorp and Manufacturers Hanover are striving to establish major presences accompanied by virtually all of the major New York law firms, seven of the "Big 8" CPA firms, and additional foreign and domestic banks. Major corporate tenants include the Atlantic Richfield Company (Arco), Union Oil, Pacific Telesis, Southern California Gas, Carter Hawley Hale and, within the last two years, AT & T and Colossus Corp.

The downtown financial core, where the Colossus Corp. Tower is located, is generally recognized as being bounded by the Harbor Freeway to the west, 1st Street to the south, Olive Oil Street to the east and 30th Street to the north. Just north of that core is Bunker Hill which is the focal point of Los Angeles' cultural and governmental activities, with such amenities as the Music Center and the planned Music Center expansion, new Museum of Contemporary Art, new Bella Lewitsky Dance Center, proposed Ritz Carlton Hotel, new YMCA Executive Fitness Center, new restaurants, retail and upscale housing. Bunker Hill also hosts the largest concentration of city, county, state, and federal government and judicial activities outside of Washington D.C. Accordingly, the Colossus Corp. Tower is and will continue to be ideally positioned in the heart of the growth pattern.

DOWNTOWN LOS ANGELES OFFICE MARKET

The downtown Los Angeles office market has a total inventory of approximately 20.5 million square feet with 15.3 million square feet of this inventory in Premier, Class A, and Class B properties. In those categories a total of 2.0 million square feet is available immediately with 750,000 square feet of that available for full floor users.

Annual absorption in downtown Los Angeles has averaged approximately 1.2 million square feet per year over the past five years. For the next five years, it is projected that the annual demand for downtown office space should range between 1.2 - 1.5 million square feet. This demand would be increased if major tenants from elsewhere in the Los Angeles Basin, or from elsewhere in the U.S. or the Far East, move downtown.

According to active downtown brokers, there is currently extraordinary leasing activity downtown with over 1.5 million square feet of identified tenants in the market for 25,000 square feet or more. These large tenants will relocate or commit primarily to Premier or other Class A buildings in 1985 and 1986. This level of activity is the strongest in more than three years, and indications point toward absorption of 1.5 million square feet or more in 1985 and possibly 1986.

In 1987 and 1988, approximately 3.8 million square feet of new Class A space will be introduced into the downtown area, of which approximately 3.1 million is currently unleased. New "fringe" located space being introduced in three Class A projects are scheduled for opening, with only about 1.7 million square feet of unleased space currently available in these projects. Therefore total new vacant space in 1987 and 1988 totals 4.8 million square feet.

THE COLOSSUS CORP. TOWER
INVESTMENT MEMORANDUM
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Current Rental Rates and Concessions

Latest leasing activity in the four best buildings in downtown (including the Colossus Corp. Tower) indicate the rental market to be as follows:

Term:	10-15 years (over 10,000 sq. ft.) 5 years (under 10,000 sq. ft.)
Gross Rent:	\$28-32/sf (years 1 - 5) \$32-36/sf (years 6 - 10) 90-100% of market (beyond 10 years)
Expense Stop:	\$6.50-7.00/sf (new stop if "market" bump in 11th year)
Tenant Improvements:	\$15-20 standard; usually giving \$10-15/sf over-standard; as high as \$40/sf over-standard for law firms
Free Rent:	6 - 9 months (5-year leases) 12-15 months (10-year leases) 15-18 months (15-year leases)

Typically, major international firms and law firms are demanding large tenant improvement concessions and having the landlord finance the tenant work. This is accomplished by amortizing the additional tenant work over the term of the lease. On average, this is inflating the gross rent on most leases by \$2-3/sf.

THE COLOSSUS CORP. TOWER
INVESTMENT MEMORANDUM
Page Thirteen

RENT ROLL

<u>Tenant</u>	<u>Square Feet</u>	<u>Term</u>	<u>Gross Rent</u>	<u>Expense Stop</u>	<u>Net Rent</u>	<u>Tenant Improvements</u>	<u>Free Rent</u>
Colossus	250,000	15 years	<u>Years</u> 1-5: \$35.00 with bumps to market in years 6 and 10	\$6.50	\$28.50	\$30/SF	None
MF & P (major law firm)	50,000	15 years	\$30.00 with bump to \$35 in year 6, and 90% of market in year 11	\$6.50	\$23.50	\$55/SF	12 months
Proposal 1*	60,000	10 years	\$29.00 with bump to \$33 in year 6	\$7.00	\$22.00	\$50/SF	12 months
Proposal 2*	40,000	15 years	\$30.00 with bump to \$34 in year 6 and 90% of market in year 11	\$7.00	\$23.00	\$40/SF	15 months
Spec. Space	100,000	10 years	\$31.00 with bump to market in year 6	\$7.00	\$24.00	\$35/SF	12 months

*At present time, tenant has not agreed to final lease terms; these terms represent the expected deal.

INVESTMENT MEMORANDUM
THE HASKELL TECH CENTER
SAN DIEGO, CALIFORNIA

**THE HASKELL TECH CENTER
SAN DIEGO, CALIFORNIA
INVESTMENT MEMORANDUM**

DESCRIPTION OF PROPERTY

The Haskell Tech Center is a suburban office/research and development center comprising 600,000 square feet of space: 150,000 square feet of office space in a single 8 story tower; 450,000 square feet in five 1- and 2-story R&D facilities. The project is located just off Interstate 11 in the Empire Valley/Mesa area of metropolitan San Diego.

The project consists of six buildings surrounding a one-acre Japanese garden. The relative quality of the project is very high both in terms of materials used in construction and facilities provided. The garden enclosed by the project includes a Japanese restaurant, a fitness center, tennis and volleyball courts for use by the tenants and on weekends their families. The costs of these amenities are passed through to the tenants as an additional expense.

The project is fully leased at rates approximately 15% above current market rents (see market study). The considerable leasing success was the result of being the first project to complete construction, combined with the high quality and visibility of the project. The project thus did not face the tough competition prevalent in today's severely overbuilt market.

Baby Blue Corp., the lead tenant for the project occupies approximately 40% of the total rentable square footage, taking 90,000 square feet of office and 150,000 square feet of R&D space. As the largest tenant, Baby Blue Corp. has exclusive signage rights on the buildings. Baby Blue Corp. is an advanced technology company specializing in computer widget lubrication, a fast growing, but highly competitive field in hardware manufacturing. Baby Blue Corp. has been a leader in this field since its founding in 1974. Acquired in 1984 by the New York Stock Exchange Blue Chip firm of General Synergy Corp. (a major technology conglomerate), Baby Blue Corp. recently has been facing stiff competition in its product lines and reported a 13% decline in sales last year and a corresponding 20% decline in margins.

The balance of the space is taken by national, high quality tenants such as Hues Corp. and Lockneed Corp. A rent roll summarizing the leases is included herein.

DESCRIPTION OF FINANCIAL DEAL

One month ago, Neal N. Prey, the Los Angeles office acquisition person, discovered the opportunity to acquire a joint venture interest in The Haskell Tech Center. At the time, Eddie Haskell, an elderly gentleman, had just begun considering the possibility of selling an equity interest in the project to fund the "gap" between his mortgage commitment and his costs.

The first mortgage loan commitment was received 90 days ago. Eddie was very disappointed that no lender would provide a loan in excess of \$52,000,000 (at 11.5%, the then current market rate, for a term of 10 years, with no amortization for the first three years). Given Haskell's total projected cost, through breakeven, of \$70-\$71 million, Neal proposed a deal structure which seemed to satisfy Haskell's major concerns:

- (1) Pull out enough equity to meet his full cost obligations,
- (2) Pull out an upfront profit of \$2-\$3 million,
- (3) Keep a minimum of 25% of the equity, including an "imputed equity" level on both cash flow and sales proceeds, and
- (4) Maintain property management.

Neal, a quick and savvy acquisition person looked at Eddie's proforma and priced the deal as follows:

- | | |
|--|--------------|
| (1) Free and Clear NOI (Net Operating Income): | \$ 8,075,000 |
| (2) Appropriate Cap Rate: | 10 percent |
| (3) Property Value | \$80,750,000 |

Neal reasoned to Haskell that a 10 percent cap rate was appropriate due to the fact that (1) most (over 52%) of the project is leased for 6 years or less, giving more risk to the cash flow, (2) the current overbuilt situation (see market study) means that the project is leased at rents in excess of current market levels, and (3) the credit of the major tenant, Baby Blue Corp., is questionable.

THE HASKELL TECH CENTER
INVESTMENT MEMORANDUM
Page Three

Valuing the property at roughly \$81,000,000, Neal offered Haskell \$21,750,000 for a 75 percent interest in the project:

JMEDIP Equity:	\$21,750,000 (75 percent)
Haskell's Imputed Equity:	<u>7,250,000</u> (25 percent)
Total Equity	\$29,000,000
Loan	<u>52,000,000</u>
Property Value	\$81,000,000 =====

Neal and Eddie agreed that JMEDIP would receive an 8 percent guaranteed return in 1986 and 1987, and Eddie would keep any excess cash flow. After 1987, cash flow would be shared as follows:

Level 1:	\$1,740,000, or an 8 percent cumulative preference to JMEDIP.
Level 2:	The next \$580,000 to Haskell on a non-cumulative basis.
Level 3:	Excess proceeds shared 75/25.

Sale or refinancing (the decision to be made solely by JMEDIP) will be shared as follows:

Level 1:	Any deficiency in the cumulative return will be paid to JMEDIP.
Level 2:	JMEDIP receives \$21,750,000
Level 3:	Haskell receives \$7,250,000
Level 4:	All excess proceeds split 75/25.

JMEDIP will receive guarantees from the Haskell Company assuring completion of any tenant improvements yet to be done. Haskell will provide JMEDIP with letters of credit which fully secure the guaranteed return through 1987.

THE HASKELL TECH CENTER
INVESTMENT MEMORANDUM
Page Four

1986 STABILIZED PROFORMA (\$ 000's)

Net Revenues:
===

Building B (high-rise; 150,000 sf @ \$18/sf)	\$ 2,700
Building A/C (R & D; 120,000 sf @ \$14/sf)	1,680
Building D (R & D; 60,000 sf @ \$13/sf)	780
Building E/F (R & D; 70,000 sf @ \$12/sf)	840
Building G/H (R & D; 150,000 sf @ \$13/sf)	1,950
Building I/J (R & D; 50,000 sf @ \$11/sf)	<u>550</u>
Total Net Operating Income	\$ 8,500
Less: Vacancy 5%	<u>(425)</u>
Effective Net Operating Income	8,075
Less: Debt Service	<u>(5,980)</u>
Net Cash Flow	<u>\$ 2,095</u> <u>=====</u>

THE HASKELL TECH CENTER
INVESTMENT MEMORANDUM
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ROLLOVER SCHEDULE

<u>Year</u>	<u>Square Feet</u>	<u>% of Total</u>
1986	- 0 -	0%
1987	10,000	2%
1988	- 0 -	0%
1989	180,000	30%
1990	70,000	12%
1991	50,000	8%
1992	- 0 -	0%
1993	50,000	8%
1994	<u>240,000</u>	<u>40%</u> (Baby Blue Corp.)
	600,000	100%

THE HASKELL TECH CENTER
INVESTMENT MEMORANDUM
Page Six

RENT ROLL

	<u>Square Feet</u>	<u>Term</u>	<u>Net Rent</u>
Baby Blue Corp.			
Office	90,000	9 years	\$18
R & D	150,000	9 years	\$12
Hues Corp.			
(R & D)	120,000	4 years	\$14
Lockneed Corp.			
(R & D)	60,000	4 years	\$13
Byte Mi and Son			
(R & D)	70,000	5 years	\$12
Lockneed Corp.			
(Office)	10,000	1.5 years	\$18
Chau Li's Chop Shop			
(R & D)	50,000	6 years	\$11
Silicon Sally and Assoc.			
(Office)	50,000	8 years	\$18

DEVELOPER BACKGROUND

The Haskell Company is a San Diego-based development company who has developed more than 8 million square feet of office and industrial space throughout the United States. The company currently manages 3.6 million square feet of office, industrial and R & D space. With corporate offices in Newport Beach and Denver, it is headquartered in the Haskell Tech Center, San Diego.

CRITIC SUMMARY

Strengths:

- Physically attractive, institutional quality office park.
- Full leasing is a result of excellent timing and strength of demand for above-average space.
- No rollover risk for next three years.
- Deal structure gives JMBDIP a higher than normal cash flow return during first 2 years.
- Deal structure is better than average in terms of pricing off of face rents.

Weaknesses:

- While Baby Blue Corp. has been acquired by a major corporation with excellent credit, the parent has not agreed to guarantee Baby Blue Corp.'s lease obligation. The creditworthiness of the Baby Blue Corp. unit by itself is difficult to determine. Baby Blue Corp. is the only lease over 6 years (9 years).
- Current severe softness in market could last 4-5 years before equilibrium returns. Due to recent emergence of the Empire Valley market, any long-term absorption trend is difficult to discern (particularly in light of the current difficulties of many high-tech firms). With most leases five years or less, lots of rollover risk for JMBDIP in 4-6th year of ownership. No protection for this under current structure.

SITE AND AREA DESCRIPTION

The building is located on Sassafrass Road, just off Elm Blvd. in the Empire Valley/Mesa area of metropolitan San Diego. The project sits on a bluff overlooking Empire Valley and Interstate 805, providing both excellent visibility and immediate access to Interstate 11.

Immediately to the west of the site is Empire Valley, Torrey Pines and the University of San Diego. Proximity to the University, the Salk and Scripps Institutes and other research centers has caused this region to become the primary R&D center for the San Diego metropolitan area.

To the south lies a suburban office district of growing importance, University Town Center-Golden Triangle. This area in turn borders on the major residential areas of La Jolla and University City.

To the north lie the residential areas of Carlsbad, Encinitas and Solana Beach.

Downtown San Diego lies 15 minutes south of the project. Transportation is excellent based on proximity to I-11 and the San Diego Freeway, both for access to Downtown and to Mission Valley, the other significant office district.

DEMOGRAPHIC TRENDS AND PROJECTIONS:

Population:

The population of the San Diego metropolitan area, which includes La Jolla, Mission Valley, Empire Valley and Old Town was estimated at 962,000 in 1984. Over the past five years growth has occurred at an average annual rate of approximately 2.41%. This rate of growth is expected to continue through 1990. Growth has occurred primarily along Mission Valley and I-11, a trend that is expected to continue.

Employment:

The composition of employment has changed little over the past ten years. A major area employer is the U.S. Navy which maintains one of its largest bases in the city of San Diego.

The Service industry is the largest employer covering 25% of the work force. This includes businesses involved in tourism, health care accounting and legal services. This sector has grown continuously for the past five years.

Employment: (continued)

The second largest employer is the Retail Trade Sector with 23.7% of total county employment in 1984.

The third largest employer in the San Diego Metropolitan area is the government, accounting for 19% of total employment. It should be noted that prior to 1979 the Government was the largest area employer.

Manufacturing was the fourth largest employment sector in 1984, accounting for 16% of total employment. Manufacturing related to advanced technology has experienced constant growth since the mid 70's. Engineering, research and development, and light manufacturing employment is the fastest growing element in this segment. The only decline in the manufacturing sector has been in canned and frozen seafood.

Office Space Supply and Demand:

Like other cities, San Diego's downtown has been the domain of financial, legal and other service industries. However, the growth of the suburban office districts has not only attracted corporations and owner-occupied structures but has also provided competition for financial and other service industries which normally locate in a downtown area. The excellent highway access (less than 15 minutes) between all the San Diego office markets makes tenant mobility an important factor when evaluating the submarkets of development.

Office Space Supply:

In San Diego County there is a total inventory of 21,973,887 square feet of office space. Of this, approximately 5,932,950 (27%) is currently vacant. Empire Valley has a total inventory of 883,126 square feet with 203,119 (23%) available (see table). Projects under construction in Empire Valley total 670,511 square feet.

Average annual absorption levels since 1980 have been at 1.5m square feet for the county and 60,000 square feet for Empire Valley. Whereas the Mission Valley, Kearney Mesa and University Town Center areas have attracted financial and other service industries as well as small businesses, absorption in Empire Valley has been primarily accounted for by the advanced technology manufacturers who also use the R&D space. Due

to the recent emergence of the Empire Valley, the use of annual absorption numbers is difficult at best. For example, in 1984, 200,000 square feet of office space was leased in the Empire Valley submarket.

Most people in the market, feel that effective rental rates (after free rent and other concessions) for office space average \$1.35 per square foot per month, or \$16.20 per square foot per year. Rental rates are quoted on a triple-net basis.

THE HASKELL TECH CENTER
INVESTMENT MEMORANDUM
Page Ten

R&D Space Supply:

The two major R&D districts of Tony Pines and Empire Valley/Mesa have a combined total inventory of 14,000,000 square feet. The available square footage is 2,035,000 or 15% (table). Space under construction or approved is 1,410,000 square feet. Total annual absorption for the two areas is estimated at 700,000 square feet (table). Estimated effective net rents average \$.90 per month (\$10.80 per year) for R&D space in Empire Valley. Demand has come from high technology and scientific firms, expanding from the University area wanting to maintain their proximity to the research centers. A total of over 7 million square feet of space is proposed for this area (table). Again, absorption numbers are difficult to use. Clearly, development and leasing have accelerated over the last five years, but recent employment cutbacks by high-tech firms may severely retard this growth in the near future.

The near term trend is likely to reduce effective rents for R & D space from the current \$10.80 per square foot to as low as \$9 per square foot in the next 12 months.

Recent leasing activity in the area indicates the following:

	<u>6 Months Ago</u>	<u>Current</u>
Average Size of Lease	+30,000 sf	under 20,000 sf
Term	5 years	5 years
Face Rent	\$1.20-1.30/mo. (\$14.40-15.60/yr.)	\$1.16/mo. (\$13.92/yr.)
Tenant Work	\$15-20/sf	\$20/sf
Assume Old Lease	occasionally	usually
Free Rent	12-15 months	15-18 months

The good news is that there are good tenants for the good projects. Generally, the major concessions are being offered by the inferior location and inferior quality projects where the majority of vacant and recently completed projects are found. Projects of the quality and location of Haskell are not prevalent and have little current vacancy.

THE HASKELL TECH CENTER
INVESTMENT MEMORANDUM
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INVENTORY OF OFFICE SPACE
SAN DIEGO COUNTY

<u>Submarket</u>	<u>Existing Square Feet</u>	<u>Available Square Feet</u>	<u>Percent Available</u>
Empire Valley	883,126	203,199	23%
Downtown	6,784,451	1,696,113	25%
Mission Valley	3,153,057	504,489	16%
Kearney Mesa	2,712,151	623,795	23%
La Jolla	743,880	223,164	30%
University Town Center	1,296,775	518,710	40%
Other Areas	6,400,447	2,163,560	34%
Total:	21,973,887	5,933,030	27%

Source: JMB Realty Corporation

INVENTORY OF R&D SPACE

<u>Submarket</u>	<u>Existing Square Feet</u>	<u>Available Square Feet</u>	<u>Percent Available</u>
Empire Valley	12,000,000	1,735,000	14%
Tony Pines	2,000,000	300,000	15%

PROPOSED SPACE

	<u>Proposed</u>	<u>Under Construction/ Already Built</u>
Rivers Corporate Business Park	2,200,000 (A)	268,000 (A)
Sea View		110,000 (B)
Lush Mira Mesa Business Park	5,000,000 (B)	--
Haskell Tech		570,000 (A)
Empire Valley Science Park		213,000 (B)
Empire Corporate Center		101,000 (B)
Koll Empire Valley		137,000 (B)

(A) Strong location and good quality

(B) Poor location or poor quality

Source: JMB Realty Corporation

INVESTMENT MEMORANDUM
DRYSDALE BANK OF GEORGIA BUILDING
ATLANTA, GEORGIA

**DRYSDALE BANK OF GEORGIA BUILDING
ATLANTA, GEORGIA
INVESTMENT MEMORANDUM**

DESCRIPTION OF PROPERTY

The Drysdale Bank of Georgia (DBG) Building, named in honor of the late founder Milburn Drysdale, is a 12-story office building containing 400,000 square feet of rentable area with an adjacent six-story parking structure containing 1,400 parking spaces. The office building and parking structure are located at 200 Hathaway Parkway just off Interstate 285, on an approximately 22-acre site in Fulton County, Georgia, near the northwestern city limits of the City of Atlanta.

Completed in April 1984, the office building is a concrete structure, with a curtain wall facade of striking green spandrel glass and bronze tinted glass. The related parking structure is a precast concrete decked garage with a roof garden on top.

The office building is currently approximately 71% leased to four tenants under leases having minimum terms (not including renewal options) which vary in duration from three to 10 years with annual base rents ranging from \$19.00 to \$21.00 per square foot. The average annual base rent is approximately \$20.00 per square foot. The Drysdale Bank of Georgia occupies approximately 58% of the building as its corporate headquarters under a lease expiring in April 1994.

The tenants include the following:

<u>Tenant</u>	<u>Square Feet</u>	<u>Original Term</u>
Drysdale Bank of Georgia	232,000	10 years
Clampett Mutual Insurance Co.	26,000	10 years
Ellie Mae Broadcasting Co., Inc.	13,000	10 years
Asbury, Johnny, & Duke	13,000	10 years

The Drysdale Bank of Georgia has two consecutive 10-year renewal options at the then-prevailing market rate. Clampett Mutual Insurance Company has a 5-year renewal option at 90% of the then-prevailing market rate. Ellie Mae Broadcasting Company, Inc. has a 10-year renewal option at the then-prevailing market rate.

The following is a schedule of the expiration of present leases (assuming no renewals) and base rents allocable thereto:

<u>Year of Exp. of Lease</u>	<u>Number of Tenants</u>	<u>Square Feet</u>
1987	0	0
1989	1	13,000
1994	2	245,000
1995	1	26,000

**DRYSDALE BANK OF GEORGIA BUILDING
INVESTMENT MEMORANDUM
Page Two**

DESCRIPTION OF SELLER

The seller of the property is DoubleNaught Development Corp. which is owned through various corporate entities and holding companies by a wealthy Moldavian, Jethro Bodine. (Moldavia is a tiny European country that has recently experienced a palace coup. The monarch-in-exile is believed to be somewhere in Colorado). Bodine also owns DBG Financial Corp., the bank holding company which owns the Drysdale Bank of Georgia, which is the building's major tenant. DoubleNaught will be the lessee under the master lease described above.

DESCRIPTION OF FINANCIAL DEAL

JMB was originally interested in the Drysdale Bank of Georgia Building because of its high quality construction and location in an expanding suburban market. Unfortunately, JMB and the developer, Jethro Bodine, were very far apart on price. Because Jethro had incurred unusually high costs in order to deliver above-standard construction and high quality finishes, he was forced to ask a price higher than economically justifiable on market rental rates. Carlotta A. Portroy, the local JMB acquisitions officer, would not be deterred, and sought to find a deal structure that satisfied both parties. Carlotta knew that Jethro would accept nothing less than a price equal to his cost, and would be much more willing to do a deal with JMB if she could provide him with a small developer's profit. Carlotta, a southern belle at heart, filled her mint julep glass, leaned against the magnolia tree outside JMB's Atlanta office and restructured the deal as follows:

Bodine's Cost: \$58,000,000

Carlotta's Stabilized Proforma (1987):

Gross Rent Revenues	8,000,000
Vacancy (5%)	<u>400,000</u>
Effective Gross Revenues	7,600,000
Operating Expenses and	
Real Estate Taxes	<u>2,600,000</u>
Net Operating Income	<u>5,000,000</u>
	=====
Value at 9% Cap Rate	\$55,550,000
	=====

Thus, the highest price Carlotta could justify, using current effective market rents, would be \$55,550,000, or still \$2,450,000 below the developer's cost. Carlotta then contemplated Bodine's latest suggestion that he would master lease the building back from JMBDIP for fixed rental payments for a 15-year term. The master lease payments plus a justifiable

DRYSDALE BANK OF GEORGIA BUILDING
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residual value for the property would have a net present value at a 13% discount rate sufficient to allow Bodine to recoup his costs. Carlotta pulled her portable computer in front of her and created the following property and master lease projections:

<u>Year</u>	<u>Projected Net Cash Flow Before Tenant Improvements, Leasing Commissions and Debt Service as Projected by Carlotta (and con- firmed by JMB Critic)</u>	<u>Master Lease Payments</u>
1986	\$ 4,500,000	\$6,000,000
1987	5,000,000	6,000,000
1988	5,100,000	6,000,000
1989	5,200,000	7,000,000
1990	5,400,000	7,000,000
1991	6,500,000	7,000,000
1992	7,000,000	8,000,000
1993	7,200,000	8,000,000
1994	8,000,000	8,100,000
1995	8,100,000	8,200,000
1996	8,100,000	9,000,000
1997	8,200,000	9,000,000
1998	8,200,000	9,500,000
1999	8,500,000	9,500,000
2000	8,500,000	9,500,000

The proposed master lease payments as shown above would provide a 13% internal rate of return on an investment of approximately \$60,000,000. "I think this is it," thought Carlotta. "I can justify the higher price because of these above-market guaranteed lease payments and Bodine can pull out a small profit. He won't mind bearing the additional leasing risk because as owner of the major tenant and client or owner of most of the other tenants, he is in a position to control the leasing and rollover risk on a bulk of the space. Also, like most developers, Bodine is an optimist and believes that he can lease the property at rents in excess of his master lease obligations."

Carlotta knew that JMBDIP could arrange a first mortgage loan for the property in the amount of \$35,000,000. This loan would bear interest at 11.0% per annum, interest only, for a term of 10 years. JMBDIP's required cash at closing, then, would be \$25,000,000 to acquire 100% of the fee title to the property.

Carlotta, energized by what she considered a brilliant proposal, drained the mint julep jigger and dialed up Bodine on her cordless phone.

CRITIC SUMMARY

Strengths:

- Excellent quality building (15-20% higher in quality than other buildings in the area) located in the fastest growing section of Atlanta.
- Expensive interior finish; being image conscious, the bank spent more money on the lobby, elevators, and common areas than was economically justified (for this suburban location).
- Building is situated on top of a ridge providing excellent visibility from the freeway and panoramic views for tenants.
- Master lease results in predictable and increasing cash flows over a 15-year period.
- Leveraged internal rate of return is 14.5%.

Weaknesses:

- While the property is in an excellent general area, it is not one of the best locations within its submarket. In fact, its tertiary location is not expected to improve in the near term because most current development is occurring in other sections of its submarket. Furthermore, the property is one mile from the nearest highway interchange and the access consists of a two-lane road. The property, which is freestanding, has no amenities (such as restaurants, services, health clubs, shops) unlike most other suburban Atlanta office buildings located in high density office parks.
- The northwest Atlanta office market is substantially overbuilt.
- The master lease payments exceed the projected cash flow from the property.
- The reputation and liquidity of the seller have been rumored to be less than exemplary. While the seller holds approximately \$100 million of U.S. real estate, it has been impossible to directly collateralize his master lease payments at the DBG building.
- Nearly all leasing to date has been to the bank or to Bodine-affiliated firms.
- The building has a glitzy "art deco" look that may be too progressive for the conservative taste of the Atlanta market.
- Unclear in the current deal structure as to who is responsible for paying future tenant improvements and leasing commissions.
- High construction costs will require premium rents from outside tenants if the bank leaves; availability of this sort of tenant in the suburbs is questionable.

MARKET STUDY

Summary

In summary, the overall market and the specific submarket in which the building is located are becoming overbuilt and will remain very competitive for the next 3 to 5 years. Developers appear to be willing to do very aggressive deals on first generation space; however, significant concessions are not prevalent on rollover/second generation space.

GENERAL POPULATION/ECONOMIC OVERVIEW

Population

The State of Georgia is the 12th largest state and the 5th fastest growing state in the nation. The State's population in 1980 was approximately 5.5 million, representing 16% of the total population in the Southeast and 2.4% of the population in the nation. The primary concentration of population in the state is in the Atlanta metropolitan statistical area, which consists of 18 counties covering 5,147 square miles.

Atlanta is the 10th largest metropolitan statistical area in the nation with an estimated total population of 2.3 million in 1983. This represents a 26.7% (or 2.4% p.a.) increase from 1973 and an 8.5% (or 2.8% p.a.) increase from 1980. The major growth over the last five years has occurred in the northern suburbs, primarily in Cobb, Gwinnett and northern Fulton Counties. The seven counties which surround downtown (Clayton, Cobb, DeKalb, Douglas, Fulton, Gwinnett and Rockdale Counties) are known as the Atlanta Region and comprise approximately 83% of the MSA's total population.

Employment

Atlanta has a well-diversified economy which is not dependent on any single industry. According to the Georgia Department of Labor, Atlanta has over 2,700 manufacturers which provide 14% of the area's non-agricultural employment. The primary industries in terms of employment are metals and machinery (22%), transportation equipment (15%), food and kindred products (13%), printing and publishing (12%) and textiles and apparel (9%). The highest growth over the last ten years has been in the printing and publishing industry (74%) and the metals and machinery industry (26%). The Atlanta area is involved in predominantly high value added manufacturing versus low value added, labor intensive manufacturing. The following companies are among the major non-public employers (over 5,000 employees) in the area: General Motors, Lockheed-Georgia Corp., Western Electric, Eastern Airlines, Delta Airlines, Georgia Power, Southern Bell, Sears Roebuck & Co., and Rich's.

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Total non-agricultural employment was estimated to be 1,140,000 for the Atlanta SMSA in August, 1984 (according to the Department of Labor, State of Georgia Employment Security Agency). This represents a 7.8% increase over the prior year. A breakdown of the employment sectors is shown below:

Construction	62,000	5.4%
Manufacturing	156,000	13.7%
Transportation/Communications/Utilities	96,000	8.4%
Trade-Wholesale and Retail	325,000	28.5%
Finance/Insurance/Real Estate	78,000	6.9%
Services	258,000	22.6%
Government	165,000	14.5%
	<u>1,140,000</u>	<u>100%</u>

Total non-agricultural employment grew at a 5.4% average annual rate between 1975 and 1980 and continued to grow at a 2.9% average annual rate between 1980 and 1983. The Atlanta SMSA's unemployment rate stood at 4.8% in August, 1984 compared to 5.9% for the State of Georgia and 7.3% for the nation. The SMSA's unemployment rate has been consistently below the state and national averages for the past 5 years.

Corporate Headquarters

Due to its location, accessibility, moderate seasonal climate, cost of living and cost of labor and office space, Atlanta has become a popular national and regional headquarters location. The following Fortune 500 companies are among those which have headquarter facilities in Atlanta: Georgia Pacific, Coca Cola, Delta Airlines, Fuqua Industries, The Southern Company, Genuine Parts Co., National Service Industries, and Gold Kist.

Transportation

Atlanta was founded in 1837 as a railroad terminus and developed into the major transportation, distribution, communication, administration and financial center of the Southeast. Atlanta's geographic location made it a natural intersection for highway, rail and air routes. The area is currently served by 17 passenger airlines, 3 buslines, 2 railroad systems (comprised of seven railroad companies), several hundred regulated "for hire" motor carriers, and MARTA, which is one of the most successful mass transit bus/rail systems in North America.

Hartsfield International Airport, which is located approximately 8 miles south of downtown Atlanta, is the second busiest airport in the world and is one of the primary connecting points in the nation's air route pattern. The airport underwent a major expansion in 1980 which added an international terminal. A fourth runway is currently under construction and scheduled for completion in 1985. The airport is designed to be expandable in order to accommodate substantial growth in the future and it will be tied into the MARTA rapid rail system by 1988. The airport provides non-stop service to 119 cities and has 5 commuter lines.

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Atlanta is one of the leading interstate highway centers of the nation and is the hub of the Southeast system with six converging legs of three major interstates (75, 85, 20) and a 64-mile beltway system (285) with 8 lanes in most sections. A \$1.2 billion expansion and upgrade is currently underway on I-75, I-85, and the Downtown connector, with completion scheduled for 1986. The benefits of the roadway improvements are already being noticed by downtown commuters.

Governmental/Financial

Atlanta is also the major governmental center in both the State (being the State Capital) and the Southeast. Approximately 70 federal government agencies have southeast operations centers in Atlanta. Atlanta is also the financial hub of the region and contains the regional headquarters of the Federal Reserve Bank and the FHLB. Atlanta is expected to gain increased importance as a regional banking center as deregulation of the industry continues.

Education

The Atlanta area has 19 public school systems as well as 28-degree granting colleges, junior colleges and universities, include Emory University, Georgia Institute of Technology and Georgia State University. Atlanta is also a major center for technical and vocational training.

Summary

Atlanta is the primary transportation, distribution, convention, financial and governmental center of the Southeast and the 10th largest metropolitan statistical area in the nation. The economy of Atlanta is diversified and has a strong, growing non-agricultural employment base. The fastest growing employment sector in recent years has been Services, which currently provides 22.6% of Atlanta's non-agricultural jobs. The unemployment rate for the SMSA (as of 8/84) was 4.8% and has consistently remained below the state and national averages for the past 5 years. Atlanta is well positioned to continue growing and creating jobs due to its central and accessible location, highly developed transportation system and business infrastructure, moderate but seasonal climate and low cost of living and conducting business.

LOCATION

The DBG Building is located in the Hathaway Center, which is a 100+ acre development, comprised mostly of residential properties. The park is heavily forested and located on hills overlooking I-285 in the northwest quadrant of metropolitan Atlanta in Fulton County, Georgia. The park is approximately 1-1/2 miles northeast of the I-285/I-75 intersection (Galleria, Major Artery, Circle 75) and is bounded by the Succotash National Park and Succotash River on the west and Updown Drive (which intersects I-285 on the east. The site is located within 15 minutes of 3,500 hotel rooms, 2 major shopping malls and major restaurants. However, there are very limited amenities in the park itself as compared to projects such as the Galleria, Major Artery, Perimeter Center, etc.

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A building directly competitive with the Drysdale Bank Building is currently under construction on a site located on the north side of Hathaway Parkway overlooking the forest and river valley. The building will contain 266,000 NRSF when completed in early 1985. There are no signed leases for this building but there are rumors that the developers are negotiating with IBM as a major tenant. This 12-story building is of a competitive quality (with respect to the DBG building) and has a stainless steel accented black granite skin, a two-story marbled lobby, eight cornered offices per floor, minimal interior columns, eight elevators and an adjacent parking garage with covered access.

In addition, a third building in a multi-building sub-development is planned. This building will be interconnected with buildings I and II on 4 of 9 floors and will contain 234,000 NRSF. IBM is expected to lease this building, but there is no formal commitment.

The DBG Building is located on a 22-acre site in Hathaway Center just off of Hathaway Parkway, which is the primary road in the park that is accessible from Updown Drive (which intersects I-285) and the Major Artery Parkway. The building has excellent visibility from I-285 and magnificent panoramic views which will remain unobstructed due to the building's positioning on the side of a hill. The building is difficult to locate by those unfamiliar with the area. There is already heavy rush hour traffic into and out of the office park. The traffic problem should intensify when the DBG and the other new buildings are completed and/or leased up.

OFFICE MARKET SUMMARY

Overall Atlanta Metropolitan

71.7 million square feet of total office space with 9.7 million square feet (13.5%) vacant. Vacancy excluding owner-user space equals 16.4%. Approximately 12.7 million square feet currently under construction (4.4 million scheduled for delivery by year-end 1984). 30.7 million square feet of new space projected (by DataBank, Inc.) to be built in the next 3 years (including space currently under construction) assuming no major downturn in the economy and based on building permits, plans and zoning requests at Planning Department and conversations with developers and brokers. Estimated current net absorption level of 7 million square feet per year. Current available and under construction supply of space (excluding 5% normal vacancy factor) equals 2.6 years based on 7 million square feet per year stabilized absorption. (Assumes no new projects or phases are started).

45.4 million square feet of existing "quality" office space with 6.2 million square feet (13.6%) vacant. Approximately 9.2 million square feet currently under construction (1.4 million square feet pre-leased and 3.7 million square feet scheduled for delivery by year-end 1984). Approximately 3.8 million square feet were absorbed in 1983 and 3.6 million square feet are expected to be absorbed in 1984. Current available and under construction supply of space (excluding 5% normal vacancy factor) equals 3.5 years based on 3.75 million square feet per year stabilized absorption. (Assumes no new projects or phases are started).

Submarkets

The Atlanta office market can be broken down into 21 separate submarkets.

The largest submarket in terms of total existing space is Downtown with 10.1 million square feet (22%), followed by Cumberland/Powers Ferry with 6.7 million square feet, Buckhead/Lenox Square with 4.9 million square feet (11%) and Perimeter Center with 4.9 million square feet (11%). However, Downtown falls short of each of the other three major submarkets in terms of both current construction and recent absorption. These statistics reflect the explosive level of activity in the Cumberland/Powers Ferry, Buckhead/Lenox Square and Perimeter Center submarkets over the past five years which resulted from a major move by space users to areas easily accessible from and in closer proximity to the higher quality and safer residential areas in the northern suburbs and the more prestigious residential and retail areas in Buckhead. The Downtown area over this same period was perceived negatively as a result of crime and racial tensions, lack of nearby high-end residential areas and heavy construction on the interstate highway system.

At present, the Downtown area appears to have reached its low point and most existing tenants will probably stay and continue to expand. Downtown should also become more desirable as the area becomes increasingly accessible due to the completion of the interstate highway construction (1986) and the MARTA rail linkage to the Buckhead/Lenox Square area (1984) and the airport (1988). However, based on conversations with local developers and brokers, it is unlikely that Downtown will recapture tenants from the now well-established suburban submarkets or experience significant levels of growth at the expense of the suburban submarkets in the foreseeable future.

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Cumberland/Powers Ferry Submarket

The DBG Building is located in the Cumberland/Powers Ferry submarket which surrounds the intersection of I-285 and I-75 in northwest Atlanta and contains buildings located in both Cobb and Fulton Counties. As of June, 1984, this submarket contained 74 Class A buildings and 30 Class B buildings totaling 6.7 million square feet (excluding owner-occupied, governmental, medical, condo and business park space and buildings under 20,000 square feet). This represents 15% of the total metropolitan market and the 2nd largest submarket. Vacancy in this submarket as of 6/84 was 13.9% (Class A and B) and 14.0% (Class A), which compares to 10.1% (Class A and B) and 9.8% (Class A) for the submarket as of 12/83 and 13.6% for the total metropolitan market as of 6/84. 22 of 28 buildings reported higher occupancy in 6/84; however, 3 new buildings totaling 900,000 square feet (North 210, 200 Galleria, DBG Building) were completed in the 1st half of 1984. A total of 455,592 square feet of net absorption was reported for the sixth month period, which was by far the highest level of absorption in metropolitan Atlanta. Crow's Galleria project (Buildings 100 and 200) accounted for 25% of net absorption in the submarket. Net absorption for the twelve months of 1983 totalled 942,974 square feet, also the highest level in metropolitan Atlanta. Leases signed by IBM at Hathaway and Wildwood accounted for 320,000 square feet (34%) of the net absorption in 1983. New occupancy by national firms at the Galleria (Crow), Overlook (Crow) and Circle 75 (B.F. Saul) were also significant.

As of 6/84, there were 2.3 million square feet of Class A and B office space under construction in 15 buildings, representing 25% of total Class A and B construction in the metropolitan Atlanta market. Approximately 10% of this space was preleased. Excluding a normal 5% vacancy factor, this represents a 2.8 year supply of space assuming 1 million square feet of space per year of stabilized absorption and no new construction is started. In terms of new construction, there is substantial developable land in the area and strong developers willing to take on leasing risk. Crow alone is expected to start 2 new Class A buildings in 1985 totaling 885,000 square feet (300 Galleria and Overlook III). In addition, Lincoln Property Company has reportedly tied up a substantial office site in the southeast quadrant of I-275 and I-75 and Metro Development has control of 40 acres at the intersection of I-285 and Paces Ferry Road. Databank, Inc. estimates that a total of 6.7 million square feet of new office space will be completed by 1/88 (including projects currently under construction) based on information obtained from the local Planning Department interviews with developers and brokers. This estimate includes 1.5 to 2.0 million square feet of business park, condo and owner-user space.

Based on the foregoing, the area will become very competitive over the next few years and vacancy should increase substantially as the 2.3 million square feet under construction is delivered and the expectations of a surplus of space intensify. The area should continue to experience strong levels of absorption since it is now well established and has a strong mass of expanding firms and a large availability of relatively inexpensive high quality office space. The area is also in close proximity to Atlanta's most desirable residential areas and is accessible from all directions by the interstates (I-285 and I-75). A major negative factor, however, is the increasing level of traffic congestion. This will most likely be addressed only a piecemeal basis in the near future.

BUZZ COULON
THE BOSTON COMPANY

COLOSSUS CORPORATION TOWER

HASKELL TECH CENTER

DRYSDALE BANK

1. Location/Quality

Property Type

Location

Linkages

Construction Quality

On-site Amenities

2. Market Analysis

Current Outlook

Long-term projections

Employment base,
diversification

COLOSSUS CORPORATION TOWER

HASKELL TECH CENTER

DRYSDALE BANK

3. Leasing Status

Current Occupancy

Leasing history,
rate of leaseup

Future projections

4. Credit

Tenants

Developer

COLOSSUS CORPORATION TOWER

HASKELL TECH CENTER

DRYSDALE BANK

5. Deal Structure

Proposed Transaction
ownership position

Current Cash

Revisionary proceeds
or refinance

Reserve for operating

6. Numerical Analysis

- °rental rates and concessions
- °Determination of effective rents in the marketplace
- °Leaseup predictions and assumption of leasing risks
- °Overall upside and downside risks for each property
- °Deal structure/restructure, ranking, likelihood of closing, and what would be paid for the properties

FREMONT CALIFORNIA

SHOPPING CENTER

CASE STUDY

DATA

University Of Wisconsin

School Of Business

Real Estate

Department

SHOPPING CENTER

SUMMARY SHEET

LOCATION: Southwest corner of Mowry Avenue and Fremont Boulevard,
Fremont, California.

LAND: 37.38 acres (Excluding 15 acres owned by Montgomery Wards)

IMPROVEMENTS: Gross leaseable area of 442,564 square feet; 3,576 parking
spaces. (Excluding 184,500 square feet of Montgomery Wards)

FINANCING: As of July 1978 the property was encumbered by six mortgages
with remaining balances totaling \$3,750,823. The annual
mortgage payments total \$490,558. The interest rates on
the mortgages range from 6% to 7.5%, and the maturity dates
range from 1986 to 1992.

<u>PROFORMA 1979:</u> Gross Revenue	\$2,511,104
Net Expenses	490,948
Net Income	2,020,156
Debt Service	490,558
Cash Flow	1,529,598

1977 GROSS SALES: \$55,355,207

This figure is for the 79 tenants who report sales. The
sales per square foot for these 79 tenants was \$151 in 1977.
These figures do not include Montgomery Wards.

NUMBER OF TENANTS: 93

BOBANDRAY REALTY INVESTORS DOES NOT WARRANT OR GUARANTEE ANY INFORMATION
SUBMITTED WITH THIS OFFERING. ANY PROSPECTIVE BUYER MUST VERIFY THE INFORM-
ATION FOR HIMSELF. ONLY DESIGNATED BROKERS ARE ALLOWED TO PRESENT THIS
PROPERTY ON BEHALF OF BOBANDRAY REALTY INVESTORS.

INTRODUCTION

Bobandray Realty Investors (BARI) will entertain offers for acquisition of the Shopping Center (), Fremont, California through a tax free exchange. A 23.7 acre parcel adjacent to The may also be purchased with The at the buyer's option. This parcel is controlled by BARI through an option. While BARI expects to continue to exercise control of this parcel there is no guarantee that it will continue to be available.

No minimum value for The has been established. The terms of acquisition are to be all cash or cash to the existing loan or a new loan to be obtained by the buyer at his expense. The sale must be accomplished through a tax-free exchange for other properties to be approved by BARI prior to closing. BARI will not accept any proposal involving a guarantee, leaseback, or carried-back second mortgage.

Any offer which is subject to obtaining financing must stipulate the anticipated amount of the loan, its terms and where the loan is to be obtained.

A minimum deposit of \$50,000 must accompany an offer. An additional minimum \$150,000 or a higher sum as BARI may require as a condition of acceptance must be deposited immediately upon acceptance of a proposal by BARI. The deposits will be non-refundable except for failure or inability of BARI to satisfy any conditions of an accepted offer.

This package contains information about Center which we believe to be correct. The information is based on records in our files, conversations with the Center's management, and actual financial reports; however, we do not warrant or guarantee the accuracy of all of the information.

No further written information will be provided until an escrow has been opened by BARI and the buyer. At that time BARI will permit examination by the buyer of its records relative to the Center and provide other available data and reports BARI may have and buyer may request. All parties will be required to acknowledge, as part of the closing documentation, that BARI is relieved of all responsibility with respect to all financial information, physical condition of the center, and any other matters relating to The

This offering is being made available to a limited number of licensed real estate brokers. BARI has also reserved a list of principals with whom BARI has discussed the property on a direct basis with no broker involvement. A prospective buyer should assure himself he is working through an authorized broker or directly with BARI as advisor to BARI. BARI reserves the right to withdraw the Center from exchange for any reason without liability to any participating real estate broker or buyer.

AREA DESCRIPTION

Fremont is located on the eastern side of the San Francisco Bay approximately 22 miles south of Oakland, 15 miles north of San Jose, and 40 miles southeast of San Francisco. The city of Fremont is the fourth largest city in the Bay Area. Fremont has grown from a population of 24,100 in 1956 to 120,000 in 1975. This represents a compounded growth rate of 8% during this period. The primary trade area of the city is defined as the cities of Fremont, Newark, and Union City. The estimated population within this trade area in 1978 was 198,000 people and is expected to grow to 240,000 by 1990. It is anticipated the majority of the growth between 1978 and 1990 in Alameda County will occur within the primary trade area. Consequently, this trade area is one of the Bay Area's most rapid growth areas.

Highways in and around Fremont are excellent. The Nimitz Freeway (17) runs north to south through Fremont, connecting the city with Oakland to the north and San Jose to the south. Interstate 680 in the southeast section of the community connects Fremont with Stockton and Sacramento to the east and San Jose to the south. The Dumbarton Bridge (84) provides access to the San Francisco peninsula. The construction of the new Dumbarton Bridge should improve the accessibility to the peninsula and as a result have a favorable impact on future industrial and residential growth in the Fremont area. Fremont serves as the southern terminal for BART. This rapid transit system provides access to several major cities in the Bay Area and provides an easy commute to San Francisco. AC Transit, surface bus system, provides additional public transportation in and around Fremont. Rail transportation is provided by Southern Pacific and Western Pacific Railroads. Trucking is supplied by 50 common carriers.

The economic base of the area is diverse and should continue to grow. There are in excess of 125 plants in the area. Leading group classes are: Auto assembly, fabricated metal products, furniture manufacturing, and electronics. The following tables will show the distribution of the labor force by category, and who the major employers are in the Fremont-Newark area:

FREMONT-NEWARK AREA

LABOR FORCE DISTRIBUTION

Category	% Labor Force*
Agriculture, Agriculture Services	3.9%
Construction	3.4%
Manufacturing	31.4%
Trans/Comm/Utilities	3.7%
Retail Trade	
Wholesale Trade	20.9%
Finance/Real Estate/Insurance	3.4%
Services	15.2%
Government	17.9%
	100.0%

* Estimated Total Employment 46,730

MAJOR EMPLOYERS IN FREMONT-NEWARK AREA

Name of Company	Employment	Type of Business
General Motors	5,300	Passenger Cars, Trucks
Safeway Stores Inc	907	Grocery Distribution
Washington Hospital	595	General Hospital
City Fremont	533	Municipal Government
US Government FAA	458	Air Traffic Control
Fleming Foods	400	Grocery Distribution
CT Supply	260	Food Cans
Insured Transporters	250	Auto Transit

The city of Fremont has 5700 acres of industrial zoned land and approximately 40% is vacant. Vacant parcels range in size from 1/2 to 500 acres. The general plan has allocated for industrial development in a manner that will stimulate the economic environment of the area over the long run.

The is located in the 277 acre Central Business District of Fremont. The master plan calls for this area to be the downtown business district of Fremont. Expansion of retail space within the CBD is rigidly planned and the orderly growth pattern of this area should continue. Further development of the CBD will benefit the Increased retail activity draws a greater number of people to the area and benefits all of the merchants.

The trend of Fremont area continues to improve. Home values range from \$65,000 to \$200,000 and new homes are generally selling from \$75,000 to \$150,000. Recently Fremont has been attracting a more affluent household. This is probably a function of the available supply of vacant land, completion of the Bay Area Rapid Transit System (BART), and an award winning general plan that has resulted in a well planned city. In summary the city has great potential for accommodating future growth.

PHYSICAL DESCRIPTION

General:

The was constructed in several phases. The area which fronts on Mowry Avenue was completed in 1962. The remainder of the main mall was completed by 1965. The majority of the peripheral land construction took place between 1965 and 1967. The Marie Callender Pie Shop and the adjacent 3 store commerical building was finished in 1972. Bobs Big Boy was constructed in late 1977.

In general the stores are one story and the architecture of the different buildings is unified by a steel framed and paneled roof canopy extending across the store fronts. The stores on the main mall have double store fronts which face the parking areas and the open mall which runs through the middle of the shopping center. Heating and air conditioning for the tenants is provided by individual roof mounted units. All of the stores are sprinklered with the exception of the original section that fronts on Mowry Avenue.

Exteriors:

The mall buildings of the contain brick, concrete, tile and aggregate exteriors. Many stores facing the mall consist of red brick fronts or mosaic tile and exposed aggregate or patterned concrete block fronts. The mall overhangs are supported by metal posts, many detailed by patterned concrete blocks.

The display windows are primarily framed with aluminum casement. The malls are wide and well landscaped. Walks are comprised of smooth concrete, small exposed aggregate or brick. Numerous concrete planters and benches are located throughout the malls. Each planter contains large mature trees and flowers which are changed frequently so that the planters remain continually in bloom. The main cross mall leading to Mervyn's store contains a fountain surrounded by a flower-filled planter.

The parking areas are well landscaped with mature trees throughout. The Hub surrounds a small attractively landscaped public park which contains the Carriage House, a historical building.

Interiors:

The interiors of the stores generally consist of plaster, wood paneling and some stone veneer. Surfaces are painted or wallpapered. Ceilings are composed of acoustical plaster and sprinkler systems are installed throughout the center. Store interiors are comprised of smooth concrete, tile or terrazzo.

Physical Description - Cont'd

Access:

The main access to the is provided by Mowry Avenue or Fremont Boulevard. Mowry Avenue is the main east-west thoroughfare for Fremont and connects with the Nimitz Freeway a mile west of the shopping center. Fremont Boulevard is the main north-south thoroughfare and connects with the Nimitz Freeway (17) on the north and the Mission Pass Freeway (680) to the south. Fremont Boulevard provides five entrances to the center; Mowry Avenue two entrances; Walnut Avenue and Argonaut Way each have three entrances. The southern terminal of BART is approximately 1½ miles east of the center. A local bus system provides public transportation around the community.

Land Area: 37.38 acres

An additional 23.7 acres of land is optioned by BARI and may be assigned to the purchaser if they desire. This land has been brought under control to provide flexibility if an expansion of the center is pursued.

Parking Spaces: 3,576 spaces

Gross Leasable Area:

Floor Area	402,494 s.f.
Mezzanine Area	26,970 s.f.
Basement Area	<u>13,100 s.f.</u>
Total Area	442,564 s.f.

Montgomery Wards has 184,500 square feet of area on their 15 acres. This would result in a total building area of 626,308 square feet for the entire Shopping Center.

PROFORMA ASSUMPTIONS

1) Base Rents 1978 \$1,415,173

Base rental increases
in 1979 from releasing \$ 21,602

MERVYN'S EXPANSION

Estimated % rent on projected
sales of \$215 p.s.f. for 12,600 s.f. \$80,500

Hickory Farms \$10 x 2,800 s.f. \$28,000 \$ 108,500

\$1,545,275

- 2) Overage rents of \$1,015,815 were estimated calculated by increasing the 1978 figure by 12.5%. During the past five years overage rents have been increasing at a compounded rate of 15.75%. The largest % increase for one year was between 1975 and 1976 when it was 30.8% and the smallest increase was 13.8% between 1976 and 1977.
- 3) A 4% management fee is included in the \$120,000 Administration expense. BARI currently has a 4% management contract with the Hapsmith Company.
- 4) Property taxes are estimated to be \$265,000 in the wake of Proposition 13. Tenant reimbursements of \$70,000 were calculated on a tenant by tenant basis according to their leases.
- 5) Extraordinary expense of \$145,596 in 1977 and \$32,414 in 1978 were excluded. These were omitted because they were capitalized expenses.

FINANCIAL STATEMENTS

	Fiscal 1974	Fiscal 1975	Fiscal 1976	Fiscal 1977	Fiscal ¹ 1978	Proforma 1979	
RENTAL INCOME							
BASIC	\$1,189,653	\$1,207,347	\$1,235,199	\$1,264,618	\$1,360,206	\$1,545,289	
OVERAGE	434,753	507,702	664,223	756,056	903,278	(50,000)	3% Vacancy
GROSS REVENUE	<u>\$1,624,406</u>	<u>\$1,715,049</u>	<u>\$1,899,422</u>	<u>\$2,020,674</u>	<u>\$2,263,484</u>	<u>1,015,815</u>	
						<u>\$2,511,104</u>	
EXPENSES							
ADVERTISING & PROMOTION	\$ 21,278	\$ 20,515	\$ 19,170	\$ 21,486	\$ 17,554	\$ 22,000	
COMMON AREA MAINTENANCE	128,787	128,468	135,866	155,241	167,152	180,000	
REPRESENTATIVE ON PREMISES	29,928	38,665	46,066	59,009	59,556	70,000	
ADMINISTRATION	69,375	69,566	92,775	98,083	111,274	120,000	
REPAIRS	12,181	19,348	33,618	20,720	16,917	35,000	
INSURANCE	3,400	13,399	17,505	51,756	52,000	55,000	
PROPERTY TAXES	312,494	326,563	328,253	379,465	428,094	265,000*	
TOTAL EXPENSES	<u>\$ 577,443</u>	<u>\$ 616,524</u>	<u>\$ 673,253</u>	<u>\$ 785,760**</u>	<u>\$ 852,547**</u>	<u>\$ 747,000</u>	
TENANT REIMBURSEMENTS							
PROPERTY TAXES	\$ 100,757	\$ 91,531	\$ 92,761	\$ 123,145	\$ 174,770	\$ 70,000*	
COMMON AREA MAINTENANCE	115,585	118,467	117,353	140,632	149,557	161,052	
HUB MERCHANTS ASSOCIATION	10,390	16,363	30,966	23,019	25,095	25,000	
TOTAL TENANT REIMBURSEMENTS	<u>\$ 226,732</u>	<u>\$ 226,361</u>	<u>\$ 241,080</u>	<u>\$ 286,796</u>	<u>\$ 349,622</u>	<u>\$ 256,052</u>	
NET EXPENSES**	\$ 350,711	\$ 390,163	\$ 432,173	\$ 498,964	\$ 502,925	\$ 490,948	
NET INCOME	\$1,273,695	\$1,324,886	\$1,467,249	\$1,521,710	\$1,760,559	\$2,020,156	

* Reflects anticipated reduction in real estate taxes based on tax reform initiative (Proposition 13).

** Excludes extraordinary expenses of \$145,596 in 1977 and \$32,414 in 1978. These expenses are capital contributions and are non recurring items.

MORTGAGE SUMMARY

<u>LENDER</u>	<u>MORTGAGE BALANCE</u> <u>7/27/78</u>	<u>MONTHLY</u> <u>PAYMENT</u>	<u>INTEREST</u>	<u>MATURITY</u>
Pacific Mutual	1,641,933	20,927.00	6%	12/1/86
Mason McDuffie	1,434,114	12,886.03	6%	2/15/92
Mason McDuffie	88,980	1,140.55	6.75%	2/15/87
Mason McDuffie	63,308	824.08	7.5%	4/1/87
North Western Mutual Life Insurance Co.	331,713	3,355.00	7.25%	3/1/91
United California Mtg. Company	<u>190,775</u>	<u>1,747.15</u>	6.85%	12/1/92
	3,750,823	40,879.81 x 12 = \$490,557.72		

Loan Prepayment Penalties:

- 1) Up to a \$410,000 may be prepaid each calender year without penalty on the Pacific Mutual Mortgage. This right is non-cumulative. A 3% penalty will be assessed on any excess payment made over \$410,000.
- 2) Up to \$300,000 may be prepaid on the first Mason McDuffie Mortgage without a penalty being assessed. Regular principal amortization payments are included in the \$300,000. A 1% prepayment penalty will be assessed on any excess payment. This mortgage must be fully prepaid prior to any prepayment of the other two Mason McDuffie mortgages. The maximum prepayment on the latter two Mason McDuffie mortgages would be \$37,500 with any excess payments being assessed a 1% prepayment penalty. All of the Mason McDuffie mortgages have been sold and assigned to National Life and Accident Insurance Company.
- 3) The Northwestern Mutual mortgage may be prepaid by \$22,000 a year without penalty. Any excess payment will be assessed the following prepayment penalty: On and after 11/1/75 a 7% penalty, after 11/1/79 a 6% penalty, after 1/1/83 a 5% penalty, and after 1/1/87 a 4% penalty.
- 4) The United California Bank mortgage may be prepaid by \$25,000 a year without penalty. This right is non-cumulative though a 5% prepayment penalty will be assessed against any unpaid principal balance in excess of \$25,000. The 5% penalty will be reduced $\frac{1}{2}\%$ per annum after 11/3/72.

To prepay all loans as of January 1, 1979 would result in a total prepayment penalty of \$71,005.

FREMONT TRADE AREA & BAY AREA DEPARTMENT STORES

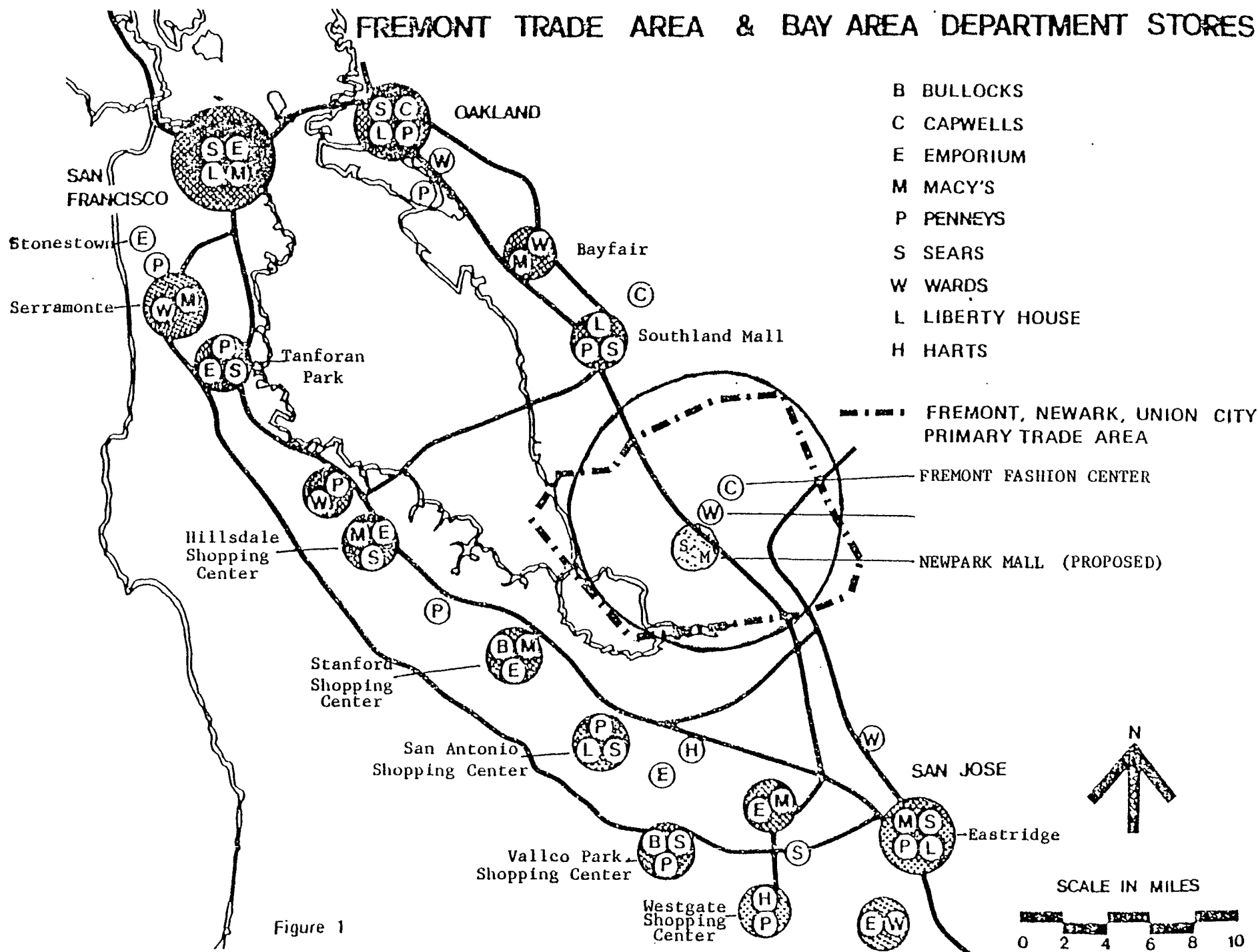
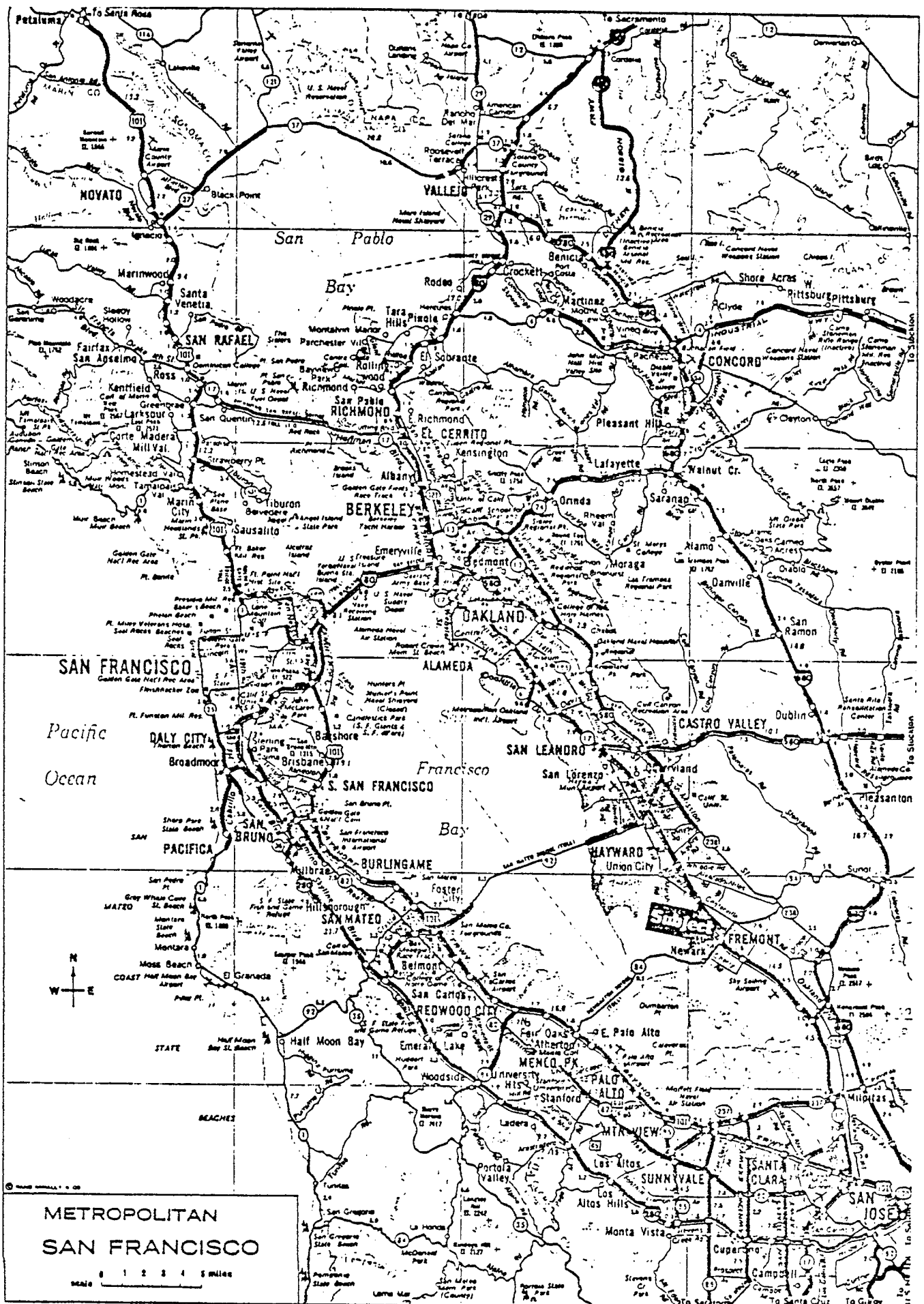


Figure 1



SHOPPING CENTER
LEASE SUMMARY
AS OF MAY 1978

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CAM %	TAX %	TAX BASE YEAR	COMMENTS
Abbey Carpets	1,368	\$10,944.00	\$ 8.00	5	11/82	5%	1.08(2)	1.1444	NET	
Allegro Music	4,200	30,240.00	7.20		9/82	6%	1.74(1)	1.7372	NET	
Allen's Shoes	4,200 1,700 base.	9,000.00	2.14	15	9/83	5%	2.44(1)	2.4404	1964-65	Taxes deducted from overage-5 yr. option same terms-CAM 1/2 of 1% Option exercised
Animal Farm	1,400	10,944.00	2.44	5	4/83	7%	1.11(2)	1.1712	NET	
Sumitomo Bank of California	6,380 1,620 Mez.	24,612.60	3.85	30	10/92	--	3.31(1)	3.2462	1963-64	CAM 15¢ per sq. ft. rent adjusted 10th & 20th year cost of living
Headazzled	2,000	24,000.00	12.00	10	3/86	8%	1.60(2)	1.6731	NET	
Bob's Big Boy	4,600	42,999.96	9.34	20	4/98	5%	1.20			
Book Mark	2,800	15,072.00	5.38	9yrs. 5mos	6/85	7%	2.32(2)	3.8482	25¢ base	
Brennan's Magnavox	2,700	12,960.00	4.80	10	9/78	4%	2.14(2)	2.2587	1968-69	September 1, 1978 expires
Century 21	1,400	4,899.96	3.50	10	11/83	--	33.20(5)	33.0892	NET	
Chancey's	3,240	15,600.00	4.81	10	12/81	5%	1.34(1)	1.3401	1964-65	
Coiffure Chic	1,033	4,586.52	4.44	5	3/80	9%	2.30(4)	10.9312	25¢ base	
Crescent Jewelers	2,800	24,000.00	8.57	12	4/89	4 1/2	1.16(1)	1.1581	NET	
Crocker Bank	6,400	24,000.00	3.75	25	5/89	--	5.10(2)	5.3540	1968-69	10 yr. option- negotiated rent

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CAM %	TAX %	TAX BASE YEAR	COMMENTS
Curto's Pipe Shop	900	\$ 7,200.00	\$ 8.00	5	10/82	7%	.71(2)	.7529	NET	
Dandy Dogs	992	3,470.88	3.50	15	11/88	6%	25.00(5)	23.4459	NET	5 yr. option same terms
Davis Baby News	3,500 2,000 mez.	18,900.00	5.40	10	10/85	6%	4.38(2)	4.6011	25¢ base	New lease 11/75; 5/77 escalates to 18,900; 11/80 escalates to 21,000
Designers Mart	3,500	17,499.96	4.99	10	5/84	5%	1.45(1)	1.4477	1974-75	
Fox Fremont	12,060	33,000.00	2.73	25	11/92	12 1/2	26.88(4)	NET		Taxes deducted from overage; 2-5 yr. option-same terms
Fremont Lock & Key	56	4,800.00	85.71	3	4/80	15%	.02(1)	.0231	NET	
Fry's Market	23,347	45,999.96	1.97	20	1/88	1 1/2	\$3499.92(4) Year	NET on Parcel 501- 976-6-10. 71.17% of 87.67% of land on Parcel 501-976-8-5		Taxes deducted from overage. CAM max. \$3500 1st ten years \$4000 second 10 years.
Gallenkamp Shoes	5,600	14,000.04	2.50	20	3/83	6%	2.32(1)	2.3163	1963-64	Taxes deducted from overage
Gallery Interiors	1,350	12,000.00	8.88	10	8/84	5%	.56(1)	.5584	1963-64	
The Gap	3,500	45,500.04	13.00	5	7/82	5%	1.45(1)	1.4477	NET	2-5 yr. options
Gift Gallery	2,975	24,990.00	8.40	10	6/86	6%	2.37(2)	1.6606	NET	
Goldman's	8,400 3,600 mez.	24,000.00	2.85	20	5/84	4 1/2	----(1)	-----	---	No CAM clause, no tax clause
Hardy Shoes	1,500	6,000.00	4.00	15	3/81	6%	1.20(2)	1.2548	1968-69	Taxes ded. from overage CAM max 1/2 of 1% 5 yr. option same terms

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CAM %	TAX %	TAX BASE YEAR	COMMENTS
Hartfield's	8,400 1,800 base.	\$18,000.00	\$ 2.14	20	1/84	4%	4.22(1)	4.2190	1966-67	Taxes deducted from overage. CAM max
House of Fabrica	5,600 1,200 base.	16,800.00	3.00	10	9/81	5%	5.42(2)	5.6886	1968-69	New lease 10/71 taxes ded. from overage
House 'N Garden	4,800	28,800.00	6.00	6	5/81	6%	3.82(2)	4.0155	.25¢ base	Original lease renewed 6/75
House of Wong	2,800	13,440.00	4.80	10	12/83	6%	1.16(1)	1.1581	1964-65	Original lease renewed 12/73
Household Finance	1,080	7,800.00	7.22	5	12/82	--	.45(1)	.4467	1963-64	Escalates to \$8400 12/80; option exercised
Barber Shop	594	4,752.00	8.00	5	12/82	6%	.25(1)	.2456		
Chevron	30,000	10,500.00	.35	20	6/88	8%	----(5)	NET		2-5 yr. options rent increase to \$12,000
Cleaners	2,160	8,676.00	4.01	15	1/83	8%	4.81(4)	22.8572	1966-67	
Flower Shop	64	2,280.00	35.62	3	10/79	6%	\$120 yr.	-----	-----	Lease renewed 11/1/76 for 3 years
Health Foods	2,800 400 mez.	19,200.00	6.00	5	5/80	5%	1.32(1)	1.3236	25¢ base	
House of Wigs	800	9,600.00	12.00	5	7/1/83	10%	.64(2)	.6692	NET	New lease 7/1/78 5 years
Mongolia BBQ	1,320	4,752.00	3.60	5	8/79	5%	23.06(3)	16.6540	25¢ base	
Shoe Repair	1,021	4,896.00	4.79	10	7/79	10-8	.81 (2)	.8541	1969-70	
Sweet Shoppe	450	4,320.00	9.60	5	9/81	8%	.19(1)	.1861	NET	New lease into effect 10/1/76
Theater Barber	466	3,727.92	8.00	5	7/1/83	9%	1.06(4)	4.9312	NET	

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CASH %	TAX %	TAX BASE YEAR	COMMENTS
Vineyard Deli	906	\$ 4,892.40	\$ 4.76	5	6/82	6%	2.01(4)	9.5873	NET	Effective 7/1/77 new lease \$4892 1st 30 months; \$5436.00 2nd 30 months
Wash and Dry	1,260	7,560.20	6.00	5	10/82	10%	14.68(3)	15.8971	NET	Lease amended 12/15/77
Ice Cream Bar	489	8,232	16.83	10	12/1/87	8%			NET	
Ivar Johnson Music	1,010	5,448.00	5.39	10	5/83	4%	.42(1)	.4177	1964-65	
Jay Vee	4,200 900 mez.	10,500.00	2.50	15	7/81	5%	4.06(2)	4.2264	1968-69	Taxes deducted from overage
Jerri B										
Karl's Shoes (National Shoe Co Ltd)	4,200 1,200 mez.	14,400.00	3.42	10	4/79	6%	4.30(2)	4.5174	1968-69	Taxes deducted from overage; lease expires 5/1/79
Kern's Cleaners	1,350	7,290.00	5.40	10	1/83	10%	.56(1)	.5584	1963-64	
King Norman's Toys	9,100 4,800 mez.	31,800.00	3.49	15	8/81	5-41/2	11.07(2)	9.2859	1968-69	
Kinney Shoes	4,900	17,150.00	3.50	20	8/86	6%	\$979.92yr(2)	4.0991	1968-69	Taxes deducted from overage
Koma	1,400	4,899.96	3.50	3	12/83	5 1/2	33.20(5)	33.0892	NET	7 yr. options-same terms
La Femme Beauty	756	4,082.40	5.40	10	12/82	8%	.31(1)	.3127	1963-64	
Dr. R.M. Layne	940	5,076.00	5.40	5	8/79	6%	.39(1)	.3888	1964-65	
Ledeem's	5,600 800 mez.	22,399.92	3.99	10	9/82	6%	5.07(2)	5.3540	1968-69	

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CAM %	TAX %	TAX BASE YEAR	COMMENTS
Liquor Hub	3,300	\$13,860.00	4.20	15	1/83	4%	7.36(4)	34.9207	1968-69	
Loard's Ice Cream	1,350	5,544.00	4.10	15	7/80	6%	15.72(3)	17.0325	1966-67	
Long's Drugs	14,900 3,184 mez. 1,250 outdoor	29,475.00	1.97	20	2/83	2%	8.00(1)	7.9831	1963-64	Taxes deducted from overage; 10 yr option, same terms CAM max 1/4 of 1%
Lyon's	6,800	35,262.36	5.18	20	3/87	5%	5.42(2)	NET	----	Taxes deducted from overage; charges deducted from overage
MacFarlane's	1,486	7,128.00	4.75	15	4/81	6%	1.18(2)	1.2431	1968-69	
Margo's Cards	2,800 400 mez.	20,160.00	7.20	10	10/86	6%	2.55(2)	2.6770	NET	20,160 1st 2 yrs 21,184 2nd 2 yrs 23,520 last 6 yrs
Marie Callender	6,650	38,400.00	5.77	25	5/98	5%	1.57(5)	NET	----	
Marlene's	4,900	12,600.00	2.57	10	1/83	5%	3.90(2)	4.0991	1968-69	Optioned exercised 5-25-77; taxes de- ducted from overage; CAM maximum 1/2 of 1%; 5 yr option same terms
Mervyn's	50,600	102,300.00	2.02	20	1/86	3%	28.21(1)	28.2099	1964-65	Taxes deducted from overage; CAM maximum 1/4 of 1%; 30 year option same terms \$24,888 ded. in in- stallments from overage for elevator
Michael's Jewelers	1,050 966 mez.	12,600.00	12.00	5	6/81	6%	.83(1)	.8065	1963-64	New Lease 6/1/76

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CAM %	TAX %	TAX BASE YEAR	COMMENTS
Milen's Jewels	2,800 2,400 base	\$13,999.92	\$ 5.00	10	1/82	3%	2.23(2)	3.3462	1968-69	Taxes deducted from overage; exercised option expires 1/31/82
Morris Fabrics	3,500	21,349.92	6.09	5	9/82	5%	2.79(2)	2.9279	NET	5 yrs net tax
Motherhood Maternity	1,050	5,400.00	5.14	10	2/84	6%	.43(1)	.4798	1964-65	Lease renewed 8/1/74
Orange Julius	400	4,980.00	12.45	15	11/81	8%	.32(2)	.3346	1968-69	2-5 yr. option terms same
Cookie Place (Potpourri lease)	356	4,800.00	13.48	5	1/81	10%	.32(2)	.2978	NET	
Price's Jr. Boots	1,380	7,344.00	5.40	10	4/83	6%	.57(1)	.5708	1963-64	Lease renewed 5/1/73
Safeway	21,528	39,839.88	1.85	20	10/82	1 1/4%	8.91(1)	12.7100	1964-65	Tax ded. from overage; CAM max. 1/4 of 1% 3-5 yr options-same terms
Sal's Pizza	3,996	14,400.00	3.60	7	4/80	7%	46.54(3)	50.4164	1966-67	5 yr. option neg. basis
Salt's Fish & Chips	1,080	12,960.00	12.00	10	2/88	5%	.86(2)	.9034	NET	
Dr. Sand	810	7,290.36	9.00	5	3/81	8%	.65(2)	.6776	25¢ base	
Sear's	2,896	14,480.04	5.00	3	12/78	--	1.20(1)	1.1979	25¢ base	
Shelly's Cocktails	1,584	7,608.00	4.80	15	6/83	6%	3.53(4)	16.7724	1968-69	
Shirtique	1,080	7,776.00	7.20	5	11/81	7%	.86(2)	.9034	NET	
Singer Company	1,320	7,920.00	6.00	10	2/84	4%	1.05(2)	1.1042	1973-74	New lease 3/1/74 Taxes ded. from overage
Smith's	8,400 3,000 mez.	21,000.00	2.50	20	3/83	4%	----(1)	4.7154	1963-64	Taxes ded. from over- age 10 yr. option-same terms CAM max. \$1,300

STORE	SQ. FT.	YEARLY MINIMUM RENT	YEARLY RENT PER SQ. FT.	LEASE TERM	LEASE EXPIRE DATE	% RENT	CAM %	TAX %	TAX BASE YEAR	COMMENTS
Sounds of Music	756	\$ 9,072.00	12.00	5	3/9/83	6%	.60(2)	.6324	NET	
Topps & Trowers	2,344	14,064.00	6.00	10	5/83	6%	.97(1)	.9695	1963-64	
Trend O' Fashion	1,935	9,675.00	5.00	10	3/83	6%	.80(1)	.8003	1963-64	
Walden Books	3,500 500 mez.	1,749.96	5.00	15yrs. 5mos.	1/87	5%	1.65(1)	1.6545	1964-65	Taxes ded. from overage
Wigs Unlimited	1,000	7,200.00	7.20	5	6/80	10%	.80(2)	.8365	NET	Effective 9/1/76 NET tax clause
Winchell's Donuts	1,150	8,280.00	7.20	10	12/88	5%	.48(1)	.4756	NET	New lease effective 1/1/78; CAM max. 1/4 of 1% new lease
Woolworth's	14,000 6,000 base.	30,000.00	2.05	15	1/88	4 1/4%	----(1)			No CAM clause, no tax clause, option exercised expires 1/88
Youngsters	8,400 3,600 mez.	48,000.00	5.71	10	3/28/88	6-5%	4.96(1)	4.9636	NET	4/1/81 rent increase to \$60,000.00, 4/1/83 rent increase to \$72,000
Vacant	11,200								NET	
Yogurt Etc.	770	6,159.96	7.99	15		8%	.61(2)	.6441	NET	
Montgomery Ward's	184,500	-----	-----	--		---	\$1740 yr.	-----		
Office	756									

Total Floor Area	402,494
Total Mezzanine	26,970
Total Basement	13,100
Total Area	442,564
Total Base Rents	1,415,172.80

SHOPPING CENTER
LEASE TURNOVER SCHEDULE

<u>DATE</u>	<u>NAME OF TENANT</u>	<u>SQUARE FEET</u>
<u>1979</u>		
April 30	Karl's Shoes	4,200
July 11	Shoe Repair	1,021
August 14	Mongolia BBQ	1,320
August 31	Dr. Layne, Optometrist	940
October 31	Flowers	<u>94</u>
		7,575 s.f. 1.9%
<u>1980</u>		
March 31	Coiffure Chic	1,033
April 14	Sal's Pizza - 5 year option on negotiated basis	3,996
April 30	Fremont Hub Lock & Key Co.	56
April 30	Wash and Dry	1,260
May 31	Health Foods	2,800
June 15	Wigs Unlimited	1,000
July 21	Loard's Ice Cream	<u>1,350</u>
		11,495 s.f. 2.86%
<u>1981</u>		
January 1	Potpourri	356
March 3	Hardy Shoes - 5 year option with 6 months notice	1,500
March 15	Dr. Sand, Optometrist	810
April 24	MacFarlane's Candies	1,486
May 31	House 'N Gardens	4,800
May 31	Michael's Jewelers	2,016
July 27	Jay Vee	5,100
August 23	King Norman's	9,100

1981 (cont'd)

September 30	House of Fabrics	6,800
September 30	Sweet Shoppe	450
November 2	Orange Julius - 2 - 5 year options with 6 months notice	400
November 30	Shirtique	1,080
December 31	Chancey's Restaurant	<u>3,240</u>

37,138 s.f. 9.2%

1982

January 31	Milen's Jewelers.	2,800
June 30	Vineyard Deli	906
July 25	Gap - 2 - 5 year options with rent increase	3,500
September 18	Ledeen's	5,600
September 24	Allegro Music	4,200
September 29	Morris Fabrics	3,500
October 1	Curto's Pipe Shop	900
October 31	Safeway 3 - 5 year options with 180 days notice	21,528
November 16	Abbey Carpets	1,368
December 6	La Femme Beauty Salon	756
December 12	Barber Shop	594
December 31	Household Finance	<u>1,080</u>

46,732 s.f. 11.6%

1983

January 13	Liquor Hub	3,300
January 13	Cleaners	2,160
January 23	Kern's Cleaners	1,350
January 31	Marlene's	4,900
February 1	Long's - 10 year option with 6 months notice	14,900

1983 (cont'd)

March 27	Gallenkamp Shoes	5,600
March 27	Smith's - 10 year option with 6 months notice	8,400
March 31	Trend O' Fashion	1,935
April 30	Price' Jr. Boot Shop	1,380
May 14	Topps & Trowers	2,344
May 31	Ivar Johnson Music	1,010
June 3	Shelly's Cocktail Lounge	1,584
July 1	House of Wigs	800
July 7	Theater Barber Shop	466
September 3	Allen's Shoes	4,200
November 30	Century 21 Real Estate	1,400
December 16	KOMA Restaurant	1,400
December 22	House of Wong	<u>2,800</u>

59,929 s.f. 14.9%

1984

January 31	Hartfield's	8,400
February 28	Motherhood Maternity	1,050
February 28	Singer Company	1,320
May 31	Goldman's	8,400
May 31	Designer Center	3,500
August 31	Gallery Interiors	<u>1,350</u>

24,020 s.f. 6%

1985

June 16	Book Mark	2,800
October 31	Davis Baby News	<u>3,500</u>

6,300 s.f. 1.6%

1986

January 31	Mervyn's - 10 year option with 2 year notice	50,600
March 31	Beadazzled	2,000
June 28	Gift Gallery	2,975
August 31	Kinney Shoes	4,900
October 1	Margo's	<u>2,800</u>
		63,275 s.f. 15.7%

1987

January 31	Walden Books	3,500
March 6	Lyon's Restaurant	<u>6,800</u>
		10,300 s.f. 2.6%

1988

January 28	Fry's Market	23,347
January 31	Woolworth's	14,000
February 1	H. Salt Fish & Chips	1,080
June 30	Chevron 2 - 5 year options with 60 days notice with rent increase	30,000
November 30	Dandy Dogs 5 year option with 90 days notice	992
December 31	Winchell's Donuts	<u>1,150</u>
		70,569 s.f. 17.5%

1989

April 30	Crescent Jewelers	2,800
May 31	Crocker Bank 10 year option with 180 day notice with negotiated rent	<u>6,400</u>
		9,200 s.f. 2.3%

1992

October 9	Bank of California	6,380
November 1	Fox Theater 2 - 5 year options with 6 month notice	<u>12,060</u>
		18,440 s.f. 4.6%

1993

March	Yogurt Etc.	770
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1998

May 24	Marie Callender's	6,650
--------	-------------------	-------

OVERAGES PAID IN 1977 *

<u>TENNANT</u>	<u>OVERAGES PAID</u>	<u>SALE P.S.F. IN 1977</u>
Abbey Carpets	3,767	\$243.42
Allegro Music	11,678	104.48
Allen's Shoes		64.04
Animal Farm		
Beadazzled		67.99
Bob's Big Boy		
Book Mark	1,556	96.09
Brennan's Magnavox		96.10
Century 21 Real Estate		
Chancey's Restaurant		43.18
Coiffure Chic	4,150	90.22
Cookie Place-Cookies Etc.		
Crescent Jewelers	16,575	231.38
Crocker Bank		
Curto's Pipe Shop		49.08
Dandy Dogs		128.83
Davis Baby News	7,952	126.96
Designer's Mart		51.95
Fotomat Drive-thru		
Fox Theatre		15.60
Fremont Hub Lock & Key	836	458.63
Fry's Food Store	50,531	265.74
Gallenkamp Shoes	18,201	111.26
Gallery Interiors		120.45
The Gap		
Gift Gallery		144.54
Goldman's	8,348	89.63
Hardy Shoes	4,695	116.12
Hartfield's	3,674	74.24
House of Fabrics		58.63
House 'N Garden		44.99
House of Wong	493	79.80
Household Finance		
Barber Shop		69.24
Cleaners	2,773	66.37
Flower Shop	62	576.23
Health Food Center	4,681	171.40
House of Wigs	1,475	81.98
Mongolian BBQ		34.87
Shoe Repair	868	63.06
Sweet Shoppe	737	118.34
Theater Barber Shop	252	70.04
Vineyard Deli	108	82.11
Wash & Dry	543	22.46
Ice Cream Bar		
Ivar H. Johnson Music Co.	1,049	175.09
Jay Vee's		47.89
jerri B		
Karl's Shoes		50.44
Kern's Cleaners & Coin-op		36.23
King Norman's Toys	23,586	130.41
Kinney Shoes	15,426	111.24

* These figures are based upon a calender year basis

<u>TENANT</u>	<u>OVERAGES PAID</u>	<u>SALE P.S.F. IN 1977</u>
Koma Restaurant		NR
La Femme Beauty Salon	256	\$ 78.45
Dr. R. M. Layne	399	91.70
Ledeen's	35,060	183.29
Liquor Hub	3,527	143.02
Loard's Ice Cream	4,375	94.57
Long's Drug Store	72,726	356.53
Lyon's Restaurant	11,939	223.81
MacFarlane's Candies	2,542	115.13
Margo's Cards & Gifts		73.13
Marie Callender	2,183	145.18
Marlene's	16,168	130.80
Mervyn's	300,885	278.79
Michael's Jewelers	20,077	534.47
Milen's Jewelers	8,031	318.18
Montgomery Ward's		
Morris Fabrics	3,184	118.39
Motherhood Maternity	728	93.15
Orange Julius	2,909	250.56
Pant Place		
Potpourri'	730	88.53
Price's Jr. Boot Shop	3,430	137.01
Real Estate Center		
Safeway	34,947	272.84
Sal's Restaurant		43.81
H. Salt Fish & Chips	10,436	380.86
Dr. Sand	13,482	325.32
Sear's Roebuck & Co.		
Shelly's Cocktail Lounge	3,807	106.43
Shirtique	1,189	
Singer Company	307	140.42
Smith's	16,586	118.91
Sounds of Music	4,622	230.14
Sumitomo Bank		
Topps & Trowsers		76.33
Trend O' Fashion		48.25
Walden Books		54.92
Wigs Unlimited	429	58.31
Winchell's Donuts	4,384	166.01
Woolworth's	6,163	70.84
Yogurt Submarine		
Youngsters	16,517	110.31
Hickory Farms	1,521	
Chevron	3,022	5.83
Stereo West	10,141	435.85
Total	784,221	

The Estate Planning Goals of Mr. Clifford

PART TWO

I. General Goals

Mr. Clifford wishes to retire from active personal management of his real estate within 5 years. However he wants to provide for the employment and retirement security of his loyal secretary and sixty year old crew foreman. His children do not wish to inherit real estate investments which require management nor does his wife. His estate is to go to his wife and then in equal parts to his children. His wife's estate is to go directly to the children if she predeceases Mr. Clifford. For the balance of his life he wants to maximize spendable cash without running the risk of outliving his income.

II. Specific Goals

Mr. Clifford realizes that he must organize his finances to reduce income taxes by at least 33% and create liquid reserves necessary to pay estate taxes and Wisconsin inheritance taxes if he and his wife perished in a common accident. He wishes to leave a bequest of \$250,000 to the University of Wisconsin Real Estate Chair.

III. The student is to design a 3-part plan:

1. Immediate reduction of taxable income by reorganization which will position Mr. Clifford to accomplish his other goals.
2. Restructure his real estate holdings consistent with his goals.
3. Basic estate plan to provide for his wife for life and his children and the University when appropriate.

Financial Detail--Mr. Paul Clifford

Subject to a current tax rate on income, capital gain, estate, and gifts reported in CCH Handbook, assuming these rates to reflect federal and state taxes combined.

Task #1: Calculate Mr. Clifford's approximate net worth, income after taxes, cash net after taxes and debt service. Suggest what problems exist in regard to his real estate holdings as indicated by this analysis.

Task #2: Establish the goals for his estate building program for Mr. Clifford and outline what must be done with the real estate to advance this plan.

Task #3: On the basis of the work sheet from Task #1 and the goals established in Task #2, show the estimated 1985 net worth position of Mr. Clifford if he follows your real estate suggestions.

Use MR CAP to analyze this situation. Take the total land cost as a single entry and then treat each of the building complexes as a single capital component taking the original cost and subtracting the land cost for that complex. Treat the common stock, bonds, and life insurance cash as a single initial working capital reserve invested at 6% after tax. Once you have determined its net worth add back personal property such as the house, personal checking account and so on. Create an expense account which includes average income tax deductions. Don't be concerned with small accounting discrepancies, confusing precision with an accurate forecast of net worth for planning purposes. Hint: Assuming the date of analysis is 1982, enter only the remaining balance on any mortgages, the original constant and the interest rate rather than the original amount of the loan.

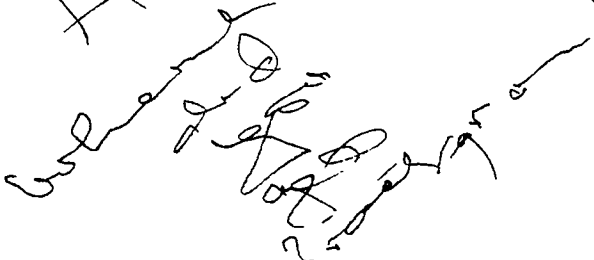
PROBLEM SET THREE

Business 850

by Kevin S Dittmar

Exce sent





MR. CLIFFORD'S ESTATE PLAN

The purpose of this problem set is to detail all of the arrangements to be undertaken with Mr. Clifford's assets with the goal of maximizing current after-tax income while passing along as much wealth as possible to desired beneficiaries. Therefore these arrangements will be comprised of strategies designed to create current tax shelter, minimize the taxable estate, and preserve as much capital appreciation as possible. The first part of this problem set will outline certain lifetime transactions necessary to achieve the goals outlined above. The second part will include the legal structuring of Mr. Clifford's will and certain inter-vivos and testamentary trusts. This part will also include some estate plan recommendations for Mrs. Clifford. The final part will summarize the types and amounts of assets that will pass to the Cliffords' children.

I. TAX MINIMIZING TRANSACTIONS

Transaction #1

*Sell \$200,000 (FMV) C. stk: \$120,000 capital gain.

*Sell \$200,000 (FMV) bonds: \$ 50,000 loss.
 \$ 70,000 net cap. gain
 ___x___20 C.G. rate
 \$ 14,000 tax

*Purchase \$400,000 (FMV) municipal bonds at 6%.

Result: 1) Holds \$300,000 (FMV) stocks
 \$400,000 (FMV) municipal bonds
 <\$14,000> tax liability

2) Offset \$50,000 in capital gains income through sale of corporate bonds.

3) Investment of proceeds into municipal bond yields attractive after tax return of 6%.

Transaction #2

THE CLIFFORD BUILDING

gr. income	105,000
vacancy	8,400
op. expenses	<u>42,000</u>
net Income	54,600 * 10(NIM) = 546,000 value (less 40K loan)

* Contribute to corporation for stock -- non-taxable under IRC sec. 351

* Give one-half of the stock to wife in a non-taxable spousal transfer under IRC sec. 1031.

* Clifford gives \$20,000 (FMV) of stock each year to one trust, having as its beneficiaries both sons of Clifford. The trust will include withdrawal rights (Crummey Doctrine) to qualify for the gift tax exclusion and will have a corporate trustee who is instructed to manage the asset in the best interests of both of the beneficiaries. Mrs. Clifford does the same thing, taking full advantage of her gift tax deductions.

* Clifford will be employed as manager of the property at a salary of \$35,000 per year, to be adjusted for inflation. This will be embodied in a management contract for life.

Result:

- 1) \$40,000 worth of appreciated property each year passed to next generation gift/estate tax free, accumulating to \$520,000 (fixed value of the corporation) by the time Clifford reaches age 70.
- 2) After the trust is completely funded the trustee may then proceed to also minimize capital gains taxes by rolling the property over in a tax free exchange or selling it on an installment basis. Regardless, the gain will be taxed at the lower marginal rate of the trust.
- 3) The trustee could also distribute the stock and recommend a complete liquidation, converting the income accumulated in the reserve account into capital gains under IRC sec. 331.

Transaction #3

HOME TOWN BUILDING

gross income	37,500
vacncy	3,000
op. expenses	<u>15,000</u>
Net Income	19,500
Dep'n	- <u>1,750</u>
Taxable NI	17,750
Rate (50%)	8,875
Dep'n	+ <u>1,750</u>
ATNI	10,625

*Sell building in an installment sale for \$200,000, the terms being 20 years, 9 percent interest, with no down payment. The monthly payments will be \$1,799 per month and \$21,593 per year.

*Mr. Clifford invests the proceeds in municipal bonds yielding 6% after taxes.

Result:

- 1) Converts low-basis asset into one providing more tax shelter by selling the asset and investing the proceeds into tax-free municipals.
- 2) Minimizes the capital gain realized on sale of appreciated property by using installment sale, causing gain to be recognized pro-rata over the 20-year payout period.

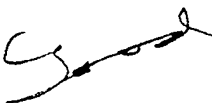
Transaction #4

NEARBY TOWN BUILDING

gross income 107,000
vacncy 8,600
op. expenses 43,000
Net Income 55,900 x 10(NIM) = \$560,000 value

* Place the building in a charitable lead trust in 1986, instructing the trustee to sell the proceeds and provide for a guaranteed return to the U.W. Real Estate Foundation of 5% of the corpus annually for 13 years with the corpus of the trust and any excess income then passing directly to and equally among his two sons. A 5% return results in a guaranteed payment of \$28,000 annually, compounded at 7% will result in an accumulation of \$500,876 to provide a permanent faculty chair for the foundation by the end of the 13th year.

- Result:
- 1) This will freeze the value of the gift on the date the gift is made, also freezing the gift/estate tax liability as the present value of the stream of payments on the date of the gift, discounted at 6% as provided by the IRC.
 - 2) The present value of the guaranteed payments to the charity results in gift tax charitable deduction for lifetime gifts under IRC sec. 2522 at least equal to the corpus of the trust, meaning that no gift/estate taxes will be due on the proceeds from the trust.
 - 3) Since the estate tax deduction covers the entire amount of the appreciated property initially placed into the trust, any capital gains liability has been completely avoided, and the entire appreciated value will pass to the sons tax-free.



Transaction #5

ADJOINING TOWN BUILDING

gross income	75,000			
vacancy	6,000			
op. expenses	- 30,000			
Net income	39,000	*	10	= \$390,000
			basis	- 76,540 (130,000 - 53,400)
				\$313,460 (gain)

INDUSTRIAL PARK BUILDING

gross income	250,000			
vacancy	20,000			
op. expenses	- 100,000			
	130,000	*	10	= \$1,300,000
			basis	- 705,600 (425,000
				-160,650-120,000)
				\$ 595,000 (gain)

* Trade the ATB and the IPB for NEW BUILDING in a tax-free exchange. Based on the given NIM, properties seem to be selling for \$13.00 per s.f. The combined equity from the two existing buildings plus the desire for a property with a conservative loan to value ratio (60%) permits us to trade for a \$3,750,000 property, encumbered by a 8.75% (recent Tenney refinance rate), 30 year loan of \$2,250,000. Given a 15% land ratio, the building itself will cost \$3,187,500, which divided by \$13.00 permits a structure with 245,192 net leasable square feet. An abbreviated cash flow statement for 1986 is presented below.

NEW BUILDING

gross income	245,192 sq.ft. * 2.75 =	675,000
	vacancy (8%)	54,000
	R. E. Taxes	67,500
	op.expende	<u>202,500</u>
	Net Income	351,000
	less dep.	101,071
	less int.	<u>196,237</u>
	taxable inc.	53,692
	plus dep.	101,071
	less prin.	<u>16,172</u>
	cash t-off	138,591

- Result:
- 1) The purpose of this transaction was to create more tax shelter for Mr.Clifford. The IRC permits one to enter into a tax free exchange of like-kind properties and permits the calculation of basis as the sum of the old basis (\$780,000) plus any new debt acquired (\$2,250,000). In this case, a non-cash expense of \$101,071 was created to shelter income.
 - 2) This transaction also permits Mr. Clifford to enjoy the full benefit of the appreciated value of his properties while at the same time deferring any capital gains.

INCOME STATEMENT (1986)

Stocks	\$300,000 @ 6.5%	\$ 19,500
Muni Bonds	400,000 @ 12%	48,000
Cash	25,000 @ 5.25%	1,312
Misc.		10,000
Mgmt. Salary		35,000
Installment Income		10,000
Real Estate Income		<u>351,000</u>
Total Net Income		\$ 474,812
Depreciation		\$101,071
Interest		176,237
Misc. Ded'ns		<u>10,000</u>
Total Deductions		\$ <u>307,308</u>
TAXABLE INCOME		\$ 167,504
Tax Rate (married ind'l filing jt. return)		* <u>.4105</u>
TAXES DUE (1986)		\$ 68,760
After Tax Net Income	\$ 98,744	
Depreciation	<u>101,071</u>	
SPENDABLE CASH AFTER TAXES		\$199,815

II. ESTATE PLAN ARRANGEMENTS

A. Create a testamentary bypass trust in Clifford's will to be funded with \$600,000 in marketable securities owned by Clifford for the benefit of his wife, with the income going to her for her life and the corpus passing to their sons at her death. This amount will pass free of any estate taxes based on his credit and the fact that it will not be included in her estate.

B. At present time place NEW BUILDING into lifetime trust with Clifford as trustee and both of them as beneficiaries. At Clifford's death, this trust and his will shall provide that the property will go into a QTIP trust, income to the wife, corpus to sons at her death. At his death, Clifford will be replaced as trustee by a corporate trustee directed to liquidate the asset when the market is favorable. This will permit the building to pass outside of probate and also keep it out of Mr. Clifford's taxable estate. All capital gains taxes will be avoided permanently by stepped-up basis at death.

C. Put insurance policy in wife's name alone to keep proceeds out of the taxable estate.

D. Give the wife the home outright during life for the same reasons of avoiding estate taxes.

E. Place provision in Mr. Clifford's will that remainder of cash and securities are to go to wife directly after payment of funeral and administrative expenses. This will cause Mr. Clifford's estate to have no estate tax liability.

F. During her life Mrs. Clifford will thus be left with approximately \$500,000 in cash and marketable securities in her own name to do with as she pleases, plus the income from almost \$4,000,000 in trust. It is recommended that she take full advantage of the annual \$10,000 per donee gift tax exclusion and consider whether there are any charities she may be interested in because her children have already been well taken care of.

III. ASSETS TO CHILDREN

The following assets will pass to the two sons of the Clifford's, in addition to any additional bequests they may receive from Mrs. Clifford:

- A. Stock of corporation holding CLIFFORD building (\$510,000), in trust
- B. Proceeds from sale of appreciated NEW building (approx. \$3,300,000), directly upon the death of Mrs. Clifford.
- C. Appreciated value of the NEARBY TOWN building (\$60,000), in trust after the U.W. charitable lead trust has expired.
- D. Corpus of the \$600,000 bypass trust upon Mrs. Clifford's death.

TOTAL: approx. \$5,000,000

MRCAP INPUT FILE

1:*1,CLIFFORD CASE,MAKOWSKI/CLIFFORD
2: 10,1986,0,1,1,0,10,245192
3: 40,675000,.03,*
4: 60,.08,*
5: 70,.10,0,*
6: 80,.30,.03,*
7: 100,.10,.50,.07
8: 101,0,10,2
9: 102,.10,1,.05,1
10: 200,1,LAND
11: 201,1,562500,0,0
12: 202,1,1,99,1
13: 200,2,EXCHANGE BUILDING
14: 201,2,3032140,1,2
15: 202,2,1,30,1
16: 300,1,EXCHANGE LOAN
17: 301,1,2250000,.0875,0,30
18: 302,1,12,1,30,0
19: 400,9
20: 403,1,2,3,4
21: 999,99

DEPRECIATION SCHEDULE FOR EXCHANGE BUILDING

INITIAL COST 3032140.
 DEPRECIATION METHOD 2 PERCENT DEPRECIABLE 1.000
 USEFUL LIFE 30. BEGINNING YEAR 1

YR	ANNUAL DEP.	CUMULATIVE STR. LINE	CUMULATIVE ACCELERATED	EXCESS
1	101071.	101071.	0.	0.
2	101071.	202143.	0.	0.
3	101071.	303214.	0.	0.
4	101071.	404285.	0.	0.
5	101071.	505357.	0.	0.
6	101071.	606428.	0.	0.
7	101071.	707499.	0.	0.
8	101071.	808571.	0.	0.
9	101071.	909642.	0.	0.
10	101071.	1010713.	0.	0.

MORTGAGE AMORTIZATION SCHEDULE FOR EXCHANGE LOAN

MORTGAGE AMOUNT 2003005. TERM 27
 INTEREST RATE .0875 MORTGAGE FACTOR .00805705
 PERIOD PAYMENT 16138.30 PAYMENTS PER YEAR 12
 BONUS INTEREST .0000 TYPE 0 GREATER THAN 0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	193660.	174507.	19153.	1983852.	0.
2	193660.	172762.	20897.	1962955.	0.
3	193660.	170859.	22801.	1940154.	0.
4	193660.	168781.	24878.	1915276.	0.
5	193660.	166515.	27144.	1888131.	0.
6	193660.	164042.	29617.	1858514.	0.
7	193660.	161344.	32315.	1826199.	0.
8	193660.	158401.	35259.	1790940.	0.

9 193660. 155189. 38471. 1752469. 0.
10 193660. 151684. 41975. 1710493. 0.

N NUMBER 0

P R O F O R M A
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 1
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PAGE 1

* GROSS RENT	\$ 845565.	* RATE OF GROWTH OF GROSS RENT	.0300
* EXPENSES	\$ 253670.	* RATE OF GROWTH OF EXPENSES	.0300
* R E TAXES	\$ 73759.	* RATE OF GROWTH OF R E TAXES	.0000
* INCOME TAX RATE	.5000	PROJECT VALUE GROWTH TYPE	2.0000
* VACANCY RATE	.0800	WORKING CAPITAL LOAN RATE	.1000
EQUITY DISCOUNT	.1000	EXTRAORDINARY EXPENSES	\$ 0.
RESALE COST	.0500	REINVESTMENT RATE	.0700
WKG CAPITAL RS\$	0.	CAPITAL RESER INTEREST RATE	.0000
INVESTOR TAX CLASS	0	OWNERSHIP FORM	1
INITIAL COST \$	3594640.	INITIAL EQUITY REQUIRED	\$ 1591635.

ALL '*' VALUES ARE AVERAGE AMOUNTS FOR HOLDING PERIOD. OF 10 YRS.

N NUMBER 0

P R O F O R M A
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 2
=====

PAGE 1

C O M P O N E N T S U M M A R Y

TITLE	PCT. DEPR	BEGIN USE	USEFUL LIFE	DEPR METHOD	COST	SCH
LAND	.00	1	99.	0	\$ 562500.	1
EXCHANGE BUILDING	1.00	1	30.	2	\$ 3032140.	1

M O R T G A G E S U M M A R Y

TITLE	INTR RATE	BEGIN YR.	END YR.	TERM	ORIG BALC	PCT VALUE
EXCHANGE LOAN	.0875	1	30	27	\$ 2003005.	.557

NUMBER 0

P R O F O R M A INVESTMENT ANALYSIS OF CLIFFORD CASE FOR MAKOWSKI/DITTMAR

REPORT SECTION NUMBER 3

PAGE 1

CASH FLOW ANALYSIS

	1998	1998	1998	1998
1 GROSS RENT	962389.	962389.	962389.	962389.
2 LESS VACANCY	76991.	76991.	76991.	76991.
3 LESS REAL ESTATE TAXES	73759.	73759.	73759.	73759.
4 LESS EXPENSES	288717.	288717.	288717.	288717.
5 NET INCOME	522922.	522922.	522922.	522922.
6 LESS DEPRECIATION	101071.	101071.	101071.	101071.
7 LESS INTEREST	151684.	151684.	151684.	151684.
8 TAXABLE INCOME	270167.	270167.	270167.	270167.
9 PLUS DEPRECIATION	101071.	101071.	101071.	101071.
10 LESS PRINCIPAL PAYMENTS	41975.	41975.	41975.	41975.
11 CASH THROW-OFF	329262.	329262.	329262.	329262.
12 LESS TAXES	135083.	135083.	135083.	135083.
13 LESS RESERVES AT .000	0.	0.	0.	0.
14 CASH FROM OPERATIONS	194179.	194179.	194179.	194179.
15 WORKING CAPITAL LOAN(CUM B)	0.	0.	0.	0.
16 DISTRIBUTABLE CASH AFR TAX	194179.	194179.	194179.	194179.
17 TAX SAVING ON OTHER INCOME	0.	0.	0.	0.
18 SPENDABLE CASH AFTER TAXES	194179.	194179.	194179.	194179.

IN NUMBER 0

P R O F O R M A
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 4
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-
PAGE 1

CASH FLOW ANALYSIS

=====	1998	1998	1998	1998
MARKET VALUE				
19 BY METHOD - 2 - AT10.0000	5229221.	5229221.	5229221.	5229221.
20 LESS RESALE COST	261461.	261461.	261461.	261461.
21 LESS LOAN BALANCES	1710493.	1710493.	1710493.	1710493.
22 PLUS CUM. CASH RESERVES	0.	0.	0.	0.
23 B/4 TAX NET WORTH	3257267.	3257267.	3257267.	3257267.
24 CAPITAL GAIN (IF SOLD)	2383833.	2383833.	2383833.	2383833.
25 CAPITAL GAINS TAX	476767.	476767.	476767.	476767.
26 TAX PREFERENCE TAX	0.	0.	0.	0.
27 INCOME TAX ON EXCESS DEP	0.	0.	0.	0.
28 TOTAL TAX ON SALE	476767.	476767.	476767.	476767.
29 AFTER TAX NET WORTH	2780500.	2780500.	2780500.	2780500.

IN NUMBER 0

P R O F O R M A
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

YEAR OF ANALYSIS

===== 1998 1998 1998 1998

BEFORE TAX RATIO ANALYSIS

=====

30	RETURN ON NET WORTH B/4 TAX	.1758	.1758	.1758	.1758
31	CHANGE IN NET WORTH B/4 TAX	207077.	207077.	207077.	207077.
32	CASH RTN ON ORIG CASH EQUIY	.2069	.2069	.2069	.2069
33	PERCENT ORIG EQUITY PAYBACK	1.6136	1.6136	1.6136	1.6136
34	PRESENT VALUE OF PROJECT	4763630.	4763630.	4763630.	4763630.

YEAR OF ANALYSIS

===== 1998 1998 1998 1998

AFTER TAX RATIO ANALYSIS

=====

35	RETURN ON NET WORTH AFT TAX	.1325	.1325	.1325	.1325
36	CHANGE IN NET WORTH AFT TAX	153842.	153842.	153842.	153842.
37	CASH RTN ON ORIG CASH EQUIY	.1220	.1220	.1220	.1220
38	PERCENT ORIG EQUITY PAYBACK	1.0324	1.0324	1.0324	1.0324
39	PRESENT VALUE OF PROJECT	4053978.	4053978.	4053978.	4053978.

40	NET INCOME-MARKET VALUE RTD	.1000	.1000	.1000	.1000
41	LENDER BONUS INTEREST RATE	.0000	.0000	.0000	.0000
42	DEFAULT RATIO	.5779	.5779	.5779	.5779

INVESTMENT ANALYSIS OF

CLIFFORD CASE

FOR

MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 7

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YEAR OF ANALYSIS

=====

1998

1998

1998

1998

MODIFIED INTERNAL RATE OF RETURN ANALYSIS

=====

RETURN ANALYSIS WITHOUT SALE

=====

41	CUM. AFT TAX SPENDABLE CASH	2220925.	2220925.	2220925.	2220925.
44	MOD. I.R.R. ON ORIG EQUITY	.0339	.0339	.0339	.0339
45	MOD. I.R.R. ON CUM. EQUITY	.0339	.0339	.0339	.0339

RETURN ANALYSIS WITH SALE

=====

46	CUM. CASH LESS ORIG EQUITY	3409790.	3409790.	3409790.	3409790.
47	CUM. CASH LESS CUM. EQUITY	3409790.	3409790.	3409790.	3409790.
48	MOD I.R.R. ON ORIG EQUITY	.1213	.1213	.1213	.1213
49	MOD I.R.R. ON CUM. EQUITY	.1213	.1213	.1213	.1213

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DEPRECIATION SCHEDULE FOR EXCHANGE BUILDING

INITIAL COST	3032140.		
DEPRECIATION METHOD	2	PERCENT DEPRECIABLE	1.000
USEFUL LIFE	30.	BEGINNING YEAR	1

YR	ANNUAL DEP.	CUMULATIVE STR. LINE	CUMULATIVE ACCELERATED	EXCESS
1	101071.	101071.	0.	0.

2	101071.	202143.	0.	0.
3	101071.	303214.	0.	0.
4	101071.	404285.	0.	0.
5	101071.	505357.	0.	0.
6	101071.	606428.	0.	0.
7	101071.	707499.	0.	0.
8	101071.	808571.	0.	0.
9	101071.	909642.	0.	0.
10	101071.	1010713.	0.	0.

R E P O R T S E C T I O N N U M B E R 8

PAGE 1

MORTGAGE AMORTIZATION SCHEDULE FOR EXCHANGE LOAN

MORTGAGE AMOUNT	2003005.	TERM	27
INTEREST RATE	.0875	MORTGAGE FACTOR	.00805705
PERIOD PAYMENT	16138.30	PAYMENTS PER YEAR	12
BONUS INTEREST	.0000	TYPE 0 GREATER THAN	0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	193660.	174507.	19153.	1983852.	0.
2	193660.	172762.	20897.	1962955.	0.
3	193660.	170859.	22801.	1940154.	0.
4	193660.	168781.	24878.	1915276.	0.
5	193660.	166515.	27144.	1888131.	0.
6	193660.	164042.	29617.	1858514.	0.
7	193660.	161344.	32315.	1826199.	0.
8	193660.	158401.	35259.	1790940.	0.
9	193660.	155189.	38471.	1752469.	0.
10	193660.	151684.	41975.	1710493.	0.

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INVESTMENT ANALYSIS OF

CLIFFORD CASE

FOR

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R E P O R T S E C T I O N N U M B E R 1

PAGE 1

* GROSS RENT	\$	845565.	* RATE OF GROWTH OF GROSS RENT	.0300
* EXPENSES	\$	253670.	* RATE OF GROWTH OF EXPENSES	.0300
* R E TAXES	\$	73759.	* RATE OF GROWTH OF R E TAXES	.0000
* INCOME TAX RATE		.5000	PROJECT VALUE GROWTH TYPE	2.0000
* VACANCY RATE		.0800	WORKING CAPITAL LOAN RATE	.1000
EQUITY DISCOUNT		.1000	EXTRAORDINARY EXPENSES	\$ 0.
RESALE COST		.0500	REINVESTMENT RATE	.0700
WKB CAPITAL RS\$		0.	CAPITAL RESER INTEREST RATE	.0000
INVESTOR TAX CLASS		0	OWNERSHIP FORM	1
INITIAL COST \$		3594640.	INITIAL EQUITY REQUIRED	\$ 1591635.

ALL '*' VALUES ARE AVERAGE AMOUNTS FOR HOLDING PERIOD. OF 10 YRS.

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R E P O R T S E C T I O N N U M B E R 2

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C O M P O N E N T S U M M A R Y

TITLE	PCT. DEPR	BEGIN USE	USEFUL LIFE	DEPR METHOD	COST	SCH
LAND	.00	1	99.	0	\$ 562500.	1
EXCHANGE BUILDING	1.00	1	30.	2	\$ 3032140.	1

M O R T G A G E S U M M A R Y

TITLE	INTR RATE	BEGIN YR.	END YR.	TERM	ORIG BALC	PCT VALUE
EXCHANGE LOAN	.0875	1	30	27	\$ 2003005.	.557

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INVESTMENT ANALYSIS OF

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FOR

MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 3

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CASH FLOW ANALYSIS

	1994	1995	1996	1997
1 GROSS RENT	855070.	880722.	907144.	934358.
2 LESS VACANCY	68406.	70458.	72572.	74749.
3 LESS REAL ESTATE TAXES	73759.	73759.	73759.	73759.
4 LESS EXPENSES	256521.	264217.	272143.	280307.
5 NET INCOME	456384.	472289.	488670.	505543.
6 LESS DEPRECIATION	101071.	101071.	101071.	101071.
7 LESS INTEREST	164042.	161344.	158401.	155189.
8 TAXABLE INCOME	191271.	209873.	229198.	249283.
9 PLUS DEPRECIATION	101071.	101071.	101071.	101071.
10 LESS PRINCIPAL PAYMENTS	29617.	32315.	35259.	38471.
11 CASH THROW-OFF	262725.	278629.	295011.	311883.
12 LESS TAXES	95635.	104936.	114599.	124642.
13 LESS RESERVES AT .000	0.	0.	0.	0.
14 CASH FROM OPERATIONS	167089.	173693.	180411.	187242.
15 WORKING CAPITAL LOAN(CUM B)	0.	0.	0.	0.
16 DISTRIBUTABLE CASH AFR TAX	167089.	173693.	180411.	187242.
17 TAX SAVING ON OTHER INCOME	0.	0.	0.	0.
18 SPENDABLE CASH AFTER TAXES	167089.	173693.	180411.	187242.

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INVESTMENT ANALYSIS OF

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CASH FLOW ANALYSIS

=====

	1994	1995	1996	1997
MARKET VALUE				
19 BY METHOD - 2 - AT10.0000	4563844.	4722887.	4886702.	5055431.
20 LESS RESALE COST	228192.	236144.	244335.	252772.
21 LESS LOAN BALANCES	1858514.	1826199.	1790940.	1752469.
22 PLUS CUM. CASH RESERVES	0.	0.	0.	0.
23 B/4 TAX NET WORTH	2477138.	2660544.	2851427.	3050191.
24 CAPITAL GAIN (IF SOLD)	1347439.	1599602.	1856297.	2117661.
25 CAPITAL GAINS TAX	269488.	319920.	371259.	423532.
26 TAX PREFERENCE TAX	0.	0.	0.	0.
27 INCOME TAX ON EXCESS DEP	0.	0.	0.	0.
28 TOTAL TAX ON SALE	269488.	319920.	371259.	423532.
29 AFTER TAX NET WORTH	2207650.	2340624.	2480168.	2626658.

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JN NUMBER 0

P R O F O R M A

INVESTMENT ANALYSIS OF

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R E P O R T S E C T I O N N U M B E R 5

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YEAR OF ANALYSIS

=====

	1994	1995	1996	1997
BEFORE TAX RATIO ANALYSIS				
30 RETURN ON NET WORTH B/4 TAX	.1908	.1865	.1826	.1791
31 CHANGE IN NET WORTH B/4 TAX	176307.	183407.	190883.	198764.
32 CASH RTN ON ORIG CASH EQUIY	.1651	.1751	.1854	.1960
33 PERCENT ORIG EQUITY PAYBACK	.8504	1.0255	1.2108	1.4068
34 PRESENT VALUE OF PROJECT	4366273.	4476254.	4578810.	4674446.

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YEAR OF ANALYSIS
=====

1994 1995 1996 1997

AFTER TAX RATIO ANALYSIS
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35	RETURN ON NET WORTH AFT TAX	.1412	.1389	.1367	.1346
36	CHANGE IN NET WORTH AFT TAX	126755.	132974.	139544.	146491.
37	CASH RTN ON ORIG CASH EQUIY	.1050	.1091	.1133	.1176
38	PERCENT ORIG EQUITY PAYBACK	.5703	.6794	.7928	.9104
39	PRESENT VALUE OF PROJECT	3900567.	3944648.	3984718.	4021070.

40	NET INCOME-MARKET VALUE RTO	.1000	.1000	.1000	.1000
41	LENDER BONUS INTEREST RATE	.0000	.0000	.0000	.0000
42	DEFAULT RATIO	.6127	.6036	.5948	.5862

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PRO FORMA
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
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YEAR OF ANALYSIS
=====

1994 1995 1996 1997

MODIFIED INTERNAL RATE OF RETURN ANALYSIS
=====

RETURN ANALYSIS WITHOUT SALE

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=====
41  CUM. AFT TAX SPENDABLE CASH 1073442. 1322275. 1595246. 1894155.
44  MOD. I.R.R. ON ORIG EQUITY   -.0635   -.0261   .0003   .0195
45  MOD. I.R.R. ON CUM. EQUITY   -.0635   -.0261   .0003   .0195

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RETURN ANALYSIS WITH SALE
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46  CUM. CASH LESS ORIG EQUITY 1689456. 2071264. 2483778. 2929178.
47  CUM. CASH LESS CUM. EQUITY 1689456. 2071264. 2483778. 2929178.
48  MOD I.R.R. ON ORIG EQUITY   .1281   .1264   .1247   .1230
49  MOD I.R.R. ON CUM. EQUITY   .1281   .1264   .1247   .1230

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DEPRECIATION SCHEDULE FOR EXCHANGE BUILDING

INITIAL COST 3032140.
DEPRECIATION METHOD 2 PERCENT DEPRECIABLE 1.000
USEFUL LIFE 30. BEGINNING YEAR 1

YR	ANNUAL DEP.	CUMULATIVE STR. LINE	CUMULATIVE ACCELERATED	EXCESS
1	101071.	101071.	0.	0.
2	101071.	202143.	0.	0.
3	101071.	303214.	0.	0.
4	101071.	404285.	0.	0.
5	101071.	505357.	0.	0.
6	101071.	606428.	0.	0.
7	101071.	707499.	0.	0.
8	101071.	808571.	0.	0.
9	101071.	909642.	0.	0.
10	101071.	1010713.	0.	0.

MORTGAGE AMORTIZATION SCHEDULE FOR EXCHANGE LOAN

MORTGAGE AMOUNT 2250000. TERM 30
INTEREST RATE .0875 MORTGAGE FACTOR .00786700
PERIOD PAYMENT 17700.75 PAYMENTS PER YEAR 12
BONUS INTEREST .0000 TYPE 0 GREATER THAN 0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	212409.	196237.	16172.	2233828.	0. <i>86</i>
2	212409.	194763.	17646.	2216182.	0. <i>87</i>
3	212409.	193156.	19253.	2196929.	0. <i>88</i>
4	212409.	191402.	21007.	2175922.	0. <i>89</i>
5	212409.	189488.	22921.	2153001.	0. <i>90</i>
6	212409.	187401.	25009.	2127993.	0. <i>91</i>
7	212409.	185122.	27287.	2100706.	0. <i>92</i>
8	212409.	182637.	29772.	2070934.	0. <i>93</i>

9	212409.	179925.	32485.	2038449.	0.54
10	212409.	176965.	35444.	2003005.	0.91~
11	212409.	175263	37146	1965558	96
12	212409	172013	40596	1925461	97
13	212409	168478	43931	1881530	1998 - yr of death

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INVESTMENT ANALYSIS OF
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FOR
MAKOWSKI/DITTMAR

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* GROSS RENT	\$	773812.	* RATE OF GROWTH OF GROSS RENT	.0300
* EXPENSES	\$	232144.	* RATE OF GROWTH OF EXPENSES	.0300
* R E TAXES	\$	67500.	* RATE OF GROWTH OF R E TAXES	.0000
* INCOME TAX RATE		.5000	PROJECT VALUE GROWTH TYPE	2.0000
* VACANCY RATE		.0800	WORKING CAPITAL LOAN RATE	.1000
EQUITY DISCOUNT		.1000	EXTRAORDINARY EXPENSES	\$ 0.
RESALE COST		.0500	REINVESTMENT RATE	.0700
WKG CAPITAL RS\$		0.	CAPITAL RESER INTEREST RATE	.0000
INVESTOR TAX CLASS		0	OWNERSHIP FORM	1
INITIAL COST \$		3594640.	INITIAL EQUITY REQUIRED	\$ 1344640.

ALL '*' VALUES ARE AVERAGE AMOUNTS FOR HOLDING PERIOD. OF 10 YRS.

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INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

REPORT SECTION NUMBER 2 PAGE 1

TITLE	PCT. DEPR	BEGIN USE	USEFUL LIFE	DEPR METHOD	COST	SCH
LAND	.00	1	99.	0	\$ 562500.	1
EXCHANGE BUILDING	1.00	1	30.	2	\$ 3032140.	1

M O R T G A G E S U M M A R Y

TITLE	INTR RATE	BEGIN YR.	END YR.	TERM	ORIG BALC	PCT VALUE
EXCHANGE LOAN	.0875	1	30	30	\$ 2250000.	.626

NUMBER 0

P R O F O R M A INVESTMENT ANALYSIS OF CLIFFORD CASE FOR MAKOWSKI/DITTMAR

REPORT SECTION NUMBER 3

PAGE 1

CASH FLOW ANALYSIS

	1986	1987	1988	1989
1 GROSS RENT	675000.	695250.	716108.	737591.
2 LESS VACANCY	54000.	55620.	57289.	59007.
3 LESS REAL ESTATE TAXES	67500.	67500.	67500.	67500.
4 LESS EXPENSES	202500.	208575.	214832.	221277.
5 NET INCOME	351000.	363555.	376487.	389806.
6 LESS DEPRECIATION	101071.	101071.	101071.	101071.
7 LESS INTEREST	196237.	194763.	193156.	191402.
8 TAXABLE INCOME	53692.	67720.	82259.	97333.
9 PLUS DEPRECIATION	101071.	101071.	101071.	101071.
10 LESS PRINCIPAL PAYMENTS	16172.	17646.	19253.	21007.
11 CASH THROW-OFF	138591.	151146.	164078.	177397.
12 LESS TAXES	26846.	33860.	41130.	48666.
13 LESS RESERVES AT .000	0.	0.	0.	0.
14 CASH FROM OPERATIONS	111745.	117286.	122948.	128731.
15 WORKING CAPITAL LOAN(CUM B)	0.	0.	0.	0.
16 DISTRIBUTABLE CASH AFR TAX	111745.	117286.	122948.	128731.
17 TAX SAVING ON OTHER INCOME	0.	0.	0.	0.
18 SPENDABLE CASH AFTER TAXES	111745.	117286.	122948.	128731.

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FOR
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CASH FLOW ANALYSIS

=====	1986	1987	1988	1989
MARKET VALUE				
19 BY METHOD - 2 - AT10.0000	3510000.	3635550.	3764866.	3898063.
20 LESS RESALE COST	175500.	181778.	188243.	194903.
21 LESS LOAN BALANCES	2233828.	2216182.	2196929.	2175922.
22 PLUS CUM. CASH RESERVES	0.	0.	0.	0.
23 B/4 TAX NET WORTH	1100673.	1237591.	1379694.	1527238.
24 CAPITAL GAIN (IF SOLD)	-159069.	61275.	285197.	512805.
25 CAPITAL GAINS TAX	-31814.	12255.	57039.	102561.
26 TAX PREFERENCE TAX	0.	0.	0.	0.
27 INCOME TAX ON EXCESS DEP	0.	0.	0.	0.
28 TOTAL TAX ON SALE	-15907.	12255.	57039.	102561.
29 AFTER TAX NET WORTH	1116579.	1225336.	1322655.	1424677.

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PROFORMA
INVESTMENT ANALYSIS OF
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FOR
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YEAR OF ANALYSIS

=====

1986

1987

1988

1989

BEFORE TAX RATIO ANALYSIS

=====

30	RETURN ON NET WORTH B/4 TAX	-.0784	.2617	.2474	.2355
31	CHANGE IN NET WORTH B/4 TAX	-243968.	136918.	142104.	147543.
32	CASH RTN ON ORIG CASH EQUIY	.1031	.1124	.1220	.1319
33	PERCENT ORIG EQUITY PAYBACK	.1031	.2155	.3375	.4694
34	PRESENT VALUE OF PROJECT	3376603.	3523708.	3660764.	3788468.

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YEAR OF ANALYSIS

=====

1986

1987

1988

1989

AFTER TAX RATIO ANALYSIS

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35	RETURN ON NET WORTH AFT TAX	-.0865	.2024	.1798	.1745
36	CHANGE IN NET WORTH AFT TAX	-228061.	108756.	97319.	102022.
37	CASH RTN ON ORIG CASH EQUIY	.0831	.0872	.0914	.0957
38	PERCENT ORIG EQUITY PAYBACK	.0831	.1703	.2618	.3575
39	PRESENT VALUE OF PROJECT	3366659.	3461191.	3534620.	3601887.

40	NET INCOME-MARKET VALUE RTO	.1000	.1000	.1000	.1000
41	LENDER BONUS INTEREST RATE	.0000	.0000	.0000	.0000
42	DEFAULT RATIO	.7147	.7026	.6909	.6795

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INVESTMENT ANALYSIS OF

CLIFFORD CASE

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YEAR OF ANALYSIS

=====

1986

1987

1988

1989

MODIFIED INTERNAL RATE OF RETURN ANALYSIS

=====

RETURN ANALYSIS WITHOUT SALE

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41	CUM. AFT TAX SPENDABLE CASH	111745.	236853.	376381.	531458.
44	MOD. I.R.R. ON ORIG EQUITY	-.9169	-.5803	-.3459	-.2071
45	MOD. I.R.R. ON CUM. EQUITY	-.9169	-.5803	-.3459	-.2071

RETURN ANALYSIS WITH SALE

=====

46	CUM. CASH LESS ORIG EQUITY	-132223.	117549.	354395.	611495.
47	CUM. CASH LESS CUM. EQUITY	-132223.	117549.	354395.	611495.
48	MOD I.R.R. ON ORIG EQUITY	-.0983	.0428	.0811	.0982
49	MOD I.R.R. ON CUM. EQUITY	-.0983	.0428	.0811	.0982

op - Program terminated.

DEPRECIATION SCHEDULE FOR EXCHANGE BUILDING

INITIAL COST 3032140.
 DEPRECIATION METHOD 2 PERCENT DEPRECIABLE 1.000
 USEFUL LIFE 30. BEGINNING YEAR 1

YR	ANNUAL DEP.	CUMULATIVE STR. LINE	CUMULATIVE ACCELERATED	EXCESS
1	101071.	101071.	0.	0.
2	101071.	202143.	0.	0.
3	101071.	303214.	0.	0.
4	101071.	404285.	0.	0.
5	101071.	505357.	0.	0.
6	101071.	606428.	0.	0.
7	101071.	707499.	0.	0.
8	101071.	808571.	0.	0.
9	101071.	909642.	0.	0.
10	101071.	1010713.	0.	0.

MORTGAGE AMORTIZATION SCHEDULE FOR EXCHANGE LOAN

MORTGAGE AMOUNT 2003005. TERM 27
 INTEREST RATE .0875 MORTGAGE FACTOR .00805705
 PERIOD PAYMENT 16138.30 PAYMENTS PER YEAR 12
 BONUS INTEREST .0000 TYPE 0 GREATER THAN 0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	193660.	174507.	19153.	1983852.	0.
2	193660.	172762.	20897.	1962955.	0.
3	193660.	170859.	22801.	1940154.	0.
4	193660.	168781.	24878.	1915276.	0.
5	193660.	166515.	27144.	1888131.	0.
6	193660.	164042.	29617.	1858514.	0.
7	193660.	161344.	32315.	1826199.	0.

8	193660.	158401.	35259.	1790940.	0.
9	193660.	155189.	38471.	1752469.	0.
10	193660.	151684.	41975.	1710493.	0.

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FOR
MAKOWSKI/DITTMAR

REPORT SECTION NUMBER 1 PAGE 1

* GROSS RENT	\$	845565.	* RATE OF GROWTH OF GROSS RENT	.0300
* EXPENSES	\$	253670.	* RATE OF GROWTH OF EXPENSES	.0300
* R E TAXES	\$	73759.	* RATE OF GROWTH OF R E TAXES	.0000
* INCOME TAX RATE		.5000	PROJECT VALUE GROWTH TYPE	2.0000
* VACANCY RATE		.0800	WORKING CAPITAL LOAN RATE	.1000
EQUITY DISCOUNT		.1000	EXTRAORDINARY EXPENSES	\$ 0.
RESALE COST		.0500	REINVESTMENT RATE	.0700
WKG CAPITAL RS\$		0.	CAPITAL RESER INTEREST RATE	.0000
INVESTOR TAX CLASS		0	OWNERSHIP FORM	1
INITIAL COST \$		3594640.	INITIAL EQUITY REQUIRED	\$ 1591635.

ALL '*' VALUES ARE AVERAGE AMOUNTS FOR HOLDING PERIOD, OF 10 YRS.

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INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

REPORT SECTION NUMBER 2 PAGE 1

TITLE	PCT. DEPR	BEGIN USE	USEFUL LIFE	DEPR METHOD	COST	SCH
LAND	.00	1	99.	0	\$ 562500.	1
EXCHANGE BUILDING	1.00	1	30.	2	\$ 3032140.	1

M O R T G A G E S U M M A R Y

TITLE	INTR RATE	BEGIN YR.	END YR.	TERM	ORIG BALC	PCT VALUE
EXCHANGE LOAN	.0875	1	30	27	\$ 2003005.	.557

JN NUMBER 0

P R O F O R M A

INVESTMENT ANALYSIS OF

CLIFFORD CASE

FOR

MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 3

PAGE 1

CASH FLOW ANALYSIS

	1990	1991	1992	1993
1 GROSS RENT	759719.	782510.	805986.	830165.
2 LESS VACANCY	60778.	62601.	64479.	66413.
3 LESS REAL ESTATE TAXES	73759.	73759.	73759.	73759.
4 LESS EXPENSES	227916.	234753.	241796.	249050.
5 NET INCOME	397267.	411397.	425952.	440943.
6 LESS DEPRECIATION	101071.	101071.	101071.	101071.
7 LESS INTEREST	172762.	170859.	168781.	166515.
8 TAXABLE INCOME	123433.	139467.	156099.	173357.
9 PLUS DEPRECIATION	101071.	101071.	101071.	101071.
10 LESS PRINCIPAL PAYMENTS	20897.	22801.	24878.	27144.
11 CASH THROW-OFF	203607.	217738.	232292.	247284.
12 LESS TAXES	61717.	69734.	78050.	86678.
13 LESS RESERVES AT .000	0.	0.	0.	0.
14 CASH FROM OPERATIONS	141890.	148004.	154243.	160605.
15 WORKING CAPITAL LOAN(CUM B)	0.	0.	0.	0.
16 DISTRIBUTABLE CASH AFR TAX	141890.	148004.	154243.	160605.
17 TAX SAVING ON OTHER INCOME	0.	0.	0.	0.
18 SPENDABLE CASH AFTER TAXES	141890.	148004.	154243.	160605.

UN NUMBER 0

PROFORMA
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR
MAKOWSKI/DITTMAR

REPORT SECTION NUMBER 4

PAGE 1

CASH FLOW ANALYSIS

=====	1990	1991	1992	1993
MARKET VALUE				
19 BY METHOD - 2 - AT10.0000	3972665.	4113973.	4259520.	4409434.
20 LESS RESALE COST	198633.	205699.	212976.	220472.
21 LESS LOAN BALANCES	1962955.	1940154.	1915276.	1888131.
22 PLUS CUM. CASH RESERVES	0.	0.	0.	0.
23 B/4 TAX NET WORTH	1811077.	1968121.	2131268.	2300831.
24 CAPITAL GAIN (IF SOLD)	381535.	616848.	856189.	1099679.
25 CAPITAL GAINS TAX	76307.	123370.	171238.	219936.
26 TAX PREFERENCE TAX	0.	0.	0.	0.
27 INCOME TAX ON EXCESS DEP	0.	0.	0.	0.
28 TOTAL TAX ON SALE	76307.	123370.	171238.	219936.
29 AFTER TAX NET WORTH	1734770.	1844751.	1960030.	2080895.

UN NUMBER 0

PROFORMA
INVESTMENT ANALYSIS OF
CLIFFORD CASE
FOR

REPORT SECTION NUMBER 5

PAGE 1

YEAR OF ANALYSIS

===== 1990 1991 1992 1993

BEFORE TAX RATIO ANALYSIS

=====

30	RETURN ON NET WORTH B/4 TAX	.2138	.2069	.2009	.1956
31	CHANGE IN NET WORTH B/4 TAX	151230.	157044.	163147.	169563.
32	CASH RTN ON ORIG CASH EQUIY	.1279	.1368	.1459	.1554
33	PERCENT ORIG EQUITY PAYBACK	.2472	.3840	.5300	.6853
34	PRESENT VALUE OF PROJECT	3840658.	3986168.	4121833.	4248327.

REPORT SECTION NUMBER 6

PAGE 1

YEAR OF ANALYSIS

===== 1990 1991 1992 1993

AFTER TAX RATIO ANALYSIS

=====

35	RETURN ON NET WORTH AFT TAX	.1515	.1487	.1461	.1436
36	CHANGE IN NET WORTH AFT TAX	104949.	109981.	115279.	120865.
37	CASH RTN ON ORIG CASH EQUIY	.0891	.0930	.0969	.1009
38	PERCENT ORIG EQUITY PAYBACK	.1745	.2675	.3644	.4653
39	PRESENT VALUE OF PROJECT	3677513.	3741005.	3799093.	3852161.

40	NET INCOME-MARKET VALUE RTD	.1000	.1000	.1000	.1000
41	LENDER BONUS INTEREST RATE	.0000	.0000	.0000	.0000
42	DEFAULT RATIO	.6520	.6417	.6318	.6221

N NUMBER 0

P R O F O R M A

INVESTMENT ANALYSIS OF

CLIFFORD CASE

FOR

MAKOWSKI/DITTMAR

R E P O R T S E C T I O N N U M B E R 7
=====

PAGE 1

YEAR OF ANALYSIS

=====

1990

1991

1992

1993

MODIFIED INTERNAL RATE OF RETURN ANALYSIS

=====

RETURN ANALYSIS WITHOUT SALE

=====

41	CUM. AFT TAX SPENDABLE CASH	287307.	455422.	641545.	847058.
44	MOD. I.R.R. ON ORIG EQUITY	-.5751	-.3410	-.2032	-.1185
45	MOD. I.R.R. ON CUM. EQUITY	-.5751	-.3410	-.2032	-.1185

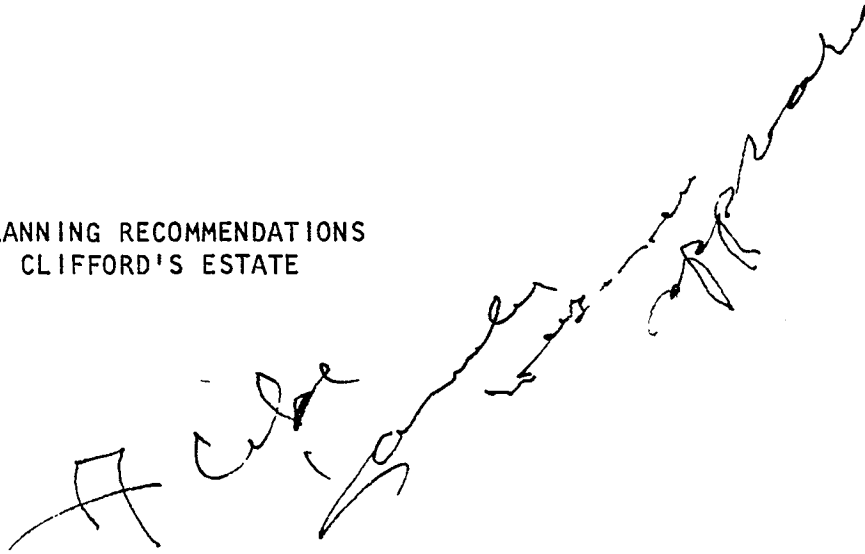
RETURN ANALYSIS WITH SALE

=====

46	CUM. CASH LESS ORIG EQUITY	430442.	708538.	1009940.	1336318.
47	CUM. CASH LESS CUM. EQUITY	430442.	708538.	1009940.	1336318.
48	MOD I.R.R. ON ORIG EQUITY	.1271	.1306	.1307	.1297
49	MOD I.R.R. ON CUM. EQUITY	.1271	.1306	.1307	.1297

op - Program terminated.

ESTATE PLANNING RECOMMENDATIONS
FOR MR. CLIFFORD'S ESTATE

A handwritten signature in black ink, appearing to read "A. Graaskamp", written diagonally across the page.

Professor Graaskamp
Business 850

John C. Stathas
April 16, 1986

I. BACKGROUND

The following estate planning recommendations for Mr. Clifford are intended to help him meet his specific objectives (see Appendix 6). The recommendations address problems highlighted in the first assignment.

II. INCORPORATE THE REAL ESTATE HOLDINGS

Clifford can reduce his overall tax rate, postpone recognition of capital gains, and provide employment and retirement security for his secretary and crew by incorporating his real estate business. Transferring the property to the corporation is not a taxable event (IRC §351). Once the corporation is established, Clifford should consider a tax free exchange of his buildings for a more diversified mix of real estate. Section 1031 of the tax code enables Clifford to trade buildings that are reaching the end of their useful lives for apartment buildings, office buildings, and even undeveloped land without recognizing gain or loss on the transfer.

The corporate form provides Clifford with a vehicle to ensure employment and retirement benefits for his secretary and his maintenance crew. Clifford should establish pension plans for his employees in the form of either a target benefit plan or a simplified employee pension plan. The target benefit plan allows the corporation to contribute the lesser of 25% of compensation or \$30,000. Target benefit plans are advantageous when employees are older and there is less time to fund their benefit. Simplified employee pension plans (SEP) allow for a maximum contribution of the lesser of 15% of compensation or \$30,000. SEPs are specifically designed for small employers and are easier to administer than any other pension plan.

The corporate form also enables Mr. Clifford to freeze the value of his (and his wife's) interest through the use of a combination of preferred and common stock. Under one approach, Cliff Company would create a new class of voting preferred stock with a stated or par liquidation value of \$1,000 per share. Cliff Company could then issue a stock dividend to Mr. Clifford of 2,872 voting preferred shares. Theoretically, the preferred stock would now represent the full value of Cliff Company and the old voting common stock would have little or no value. This stock dividend should be tax free to Mr. Clifford. Mr. Clifford could then give the shares of common stock to his children without incurring any gift tax. Should some value be attached to the common stock, Mr. and Mrs. Clifford would have to gift the stock to the children in installments (\$20,000 of common stock to each child per year).

Because the preferred stock has a stated or par liquidation value, its value is "frozen" at that level. Any future appreciation in the value of Cliff Company will accrue only to the common stock owned by the children and, therefore, will not be included in Mr. Clifford's estate. Upon Clifford's death, the preferred stock would be placed in the family trust, thereby giving an income flow (through dividends) to Mrs. Clifford.

Other possibilities within the corporation:

1. Develop a management team within the corporation to take over the corporate operations as Mr. Clifford phases out of active management.
2. Refinancing. Mr. Clifford can create tax free liquid reserves for the business by refinancing. Refinancing the real estate after it is transferred to the corporation is preferable since the proceeds would be taxed at a lower rate.
3. Corporations are taxed at lower marginal rates (see Appendix 4).

III. SEPARATE TRUSTS FOR OTHER ASSETS

Clifford's life insurance, common stock, and bonds should be placed in separate irrevocable trusts to avoid being included in Mr. Clifford's estate. A carefully drafted irrevocable life insurance trust will allow the exclusion of the insurance proceeds from both the estates of Mr. and Mrs. Clifford and will, if the terms of the trust permit discretionary loans and the purchase of estate assets, provide a source of liquidity for both estates. Placing Mr. Clifford's bonds in a QTIP trust will not only avoid having the bonds included in Mr. Clifford's estate, but also will provide \$13,000 of income to Mrs. Clifford each year after Mr. Clifford's death. When Mrs. Clifford dies, the bonds go to the children. Mr. Clifford's common stock holdings will not be included in his estate if they are placed in an irrevocable charitable remainder of the trust. The charitable remainder trust should provide that the income of the trust (\$20,000) be distributed to Mrs. Clifford. The trustee should be given the power to distribute any appreciation in the common stock holdings to Mrs. Clifford, as well as buying and selling the stock in his/her discretion to maintain the value of the trust corpus. When Mrs. Clifford dies, the \$500,000 corpus (remainder) should be distributed to the U. W. expressly to endow a Real Estate Department Chair in Mr. Clifford's name.

IV. OTHER ASPECTS OF THE ESTATE PLAN

- A. Mr. Clifford's estate plan is structured for maximum tax deferral. This is accomplished by utilizing the marital deduction to the extent that Mr. Clifford's taxable estate is reduced to \$600,000 and is offset by the unified estate tax credit. The reason why deferral is preferable to estate splitting is that under estate splitting, the best that can be done in theory (after using up the §2010 credit in both estates) is to shift property from a 50% marginal rate bracket to a 37% bracket (see Appendix 5).
- B. The use of trusts also provides for tax deferral if the trusts are given staggered fiscal year ends (see Appendix 7).

C. Although tax deferral leaves Mrs. Clifford with a large federal estate tax liability (\$1,299,663), the children have two possible ways of reducing the tax bite.

1. IRC §303 provides for stock redemption in the amount of the estate tax liability and administrative expenses to receive exchange (capital gain) rather than dividend (ordinary income) status if the stock made up more than 35% of the estate.
2. IRC §6166 provides for payment of the estate tax over 15 years. The first five years, the estate pays interest only at a rate of 4%. Over the remaining ten years, the estate pays one-tenth of the tax due each year. To qualify for the 15 year deferral, the closely held business must be at least 65% of the adjusted gross estate.

A handwritten signature or set of initials, possibly "C. Clifford", written in dark ink. The signature is stylized and appears to be written over a horizontal line.

APPENDIX 1

TABLE 1: Estate Tax Calculation (1986)

	<u>Before Estate Planning</u>	<u>After Estate Planning</u>
Gross Estate:		
Real Estate Investments	\$2,871,660	\$
Preferred Stock (Cliff Company)	-	2,871,660
Common Stocks	500,000	500,000
Bonds	200,000	200,000
Life Insurance	300,000	-
Personal Residence ($\frac{1}{2}$ Included)	40,000	40,000
Personal Property ($\frac{1}{2}$ Included)	20,000	20,000
Cash in Bank ($\frac{1}{2}$ Included)	12,500	12,500
	<u>\$3,944,160</u>	<u>\$3,644,160</u>
§2056 Marital Deduction		(700,000)
Deductions for Debt Owng	<u>(171,053)</u>	<u>(171,053)</u>
Taxable Estate	\$3,773,107	\$2,773,107
Estate Tax:	\$1,716,009	\$1,170,547
Less:		
Unified Estate Tax Credit	<u>\$ (155,800)</u>	<u>\$ (155,800)</u>
Federal Estate Tax	<u>\$1,560,209</u>	<u>\$1,014,747</u>

TABLE 2: Liquidity Position

<u>Liquid Assets</u>	<u>Before Estate Planning</u>	<u>After Estate Planning</u>
Preferred Stock (Clifford Company)	\$ -	\$2,871,660
Common Stock	500,000	-
Bonds	200,000	-
Insurance	300,000	-
Cash in Bank	25,000	25,000
	<u>\$1,025,000</u>	<u>\$2,896,660</u>

APPENDIX 2

Estate Tax at Mr. Clifford's Death - 1999

	<u>Without Estate Plan</u>	<u>With Estate Plan</u>
Gross Estate:		
* Real Estate Investments	\$4,781,525	\$ -
Personal Residence ($\frac{1}{2}$ included)	40,000	40,000
Preferred Stock (Cliff Company)	0	2,871,660
Common Stock	646,803	646,803
Bonds	200,000	200,000
Life Insurance Proceeds	300,000	-
Personal Property ($\frac{1}{2}$ included)	20,000	20,000
Cash in Bank ($\frac{1}{2}$ included)	<u>12,500</u>	<u>12,500</u>
	\$6,000,828	\$3,790,963
\$2056 Marital Deduction	<u>-</u>	<u>(3,190,963)</u>
Taxable Estate	<u>\$6,000,828</u>	<u>\$ 600,000</u>
Estate Tax:	\$2,941,256	\$ 192,800
Less:		
Unified Estate Tax Credit	<u>(192,800)</u>	<u>(192,800)</u>
Federal Estate Tax	<u><u>\$2,748,456</u></u>	<u><u>\$ -0-</u></u>

* Real Estate Investment Growth Rate assumed to be 4%.

APPENDIX 3

Estate Tax of Mrs. Clifford - 2004

Gross Estate:

Preferred Stock (Cliff Co.)	\$2,871,660
Personal Residence	80,000
Common Stock	714,123
Bonds	200,000
Personal Property	40,000
Cash in Bank	25,000
Jewelry and Securities	<u>150,000</u>
	\$4,080,783
§2055 Charitable Deduction	<u>(714,123)</u>
	<u>\$3,366,660</u>

Estate Tax:

1,290,800 + 55%(216,660) \$1,492,463

Less:

§2010 Unified Estate Tax Credit (192,800)

Federal Estate Tax

\$1,299,663

APPENDIX 4

Mr. Clifford Comparative Income Tax Statement - 1986

	Without Estate Plan	With Estate Plan	
		Clifford	Cliff Co.
Income:			
Salary	\$ -	\$100,000	\$ -
Rental Income	526,700	-	526,700
Interest Income	1,476	1,476	-
Bond Interest	13,000	13,000	-
Dividend Income	20,000	20,000	-
Miscellaneous	10,000	10,000	-
	\$571,176	\$144,476	\$526,700
Expenses	(299,582)	(10,000)	(440,832)
Taxable Income	\$271,594	\$134,476	75,868
Federal & State Tax Rate	55%	55%	15%(25,000)
			18%(25,000)
			30%(25,000)
			40%(868)
Tax Due	<u>\$149,377</u>	\$ 73,962	\$ 16,097
		<u>\$90,059</u>	

NOTE: The income tax savings should be more pronounced after Mr. Clifford's death because Clifford's preferred stock's income will be taxed at the lower trust tax rate.

APPENDIX 5

Tax Planning: Estate Splitting v. Tax Deferral

<u>Total Estate</u>	<u>Taxable Estates After Split</u>	<u>Estate Under Tax Deferral</u>
\$4,013,463	\$2,006,732	\$3,413,463
(1) Even estate splitting, tax upon death		\$ 591,299
(2) Total taxes under even estate splitting [two times (1)]		2,182,598
(3) Tax Deferral		
(a) Tax on Mr. Clifford		None
(b) Tax on Mrs. Clifford		1,325,405
(4) Taxes lost by deferral [(3) less (2)]		142,807
(5) Taxes avoided on Mr. Clifford's death under tax deferral		591,299
(6) Result of investing (5) at 10% for 5 years		952,293
(7) Interest portion [(6) less (5)]		360,994
(8) Same as (7) after 50% income tax		180,497
(9) Economic advantage of deferral		37,690

NOTE: This type of planning must be done before the death of the surviving spouse. The estate planner is therefore estimating how long the surviving spouse will live and what his/her estate will total.

APPENDIX 6

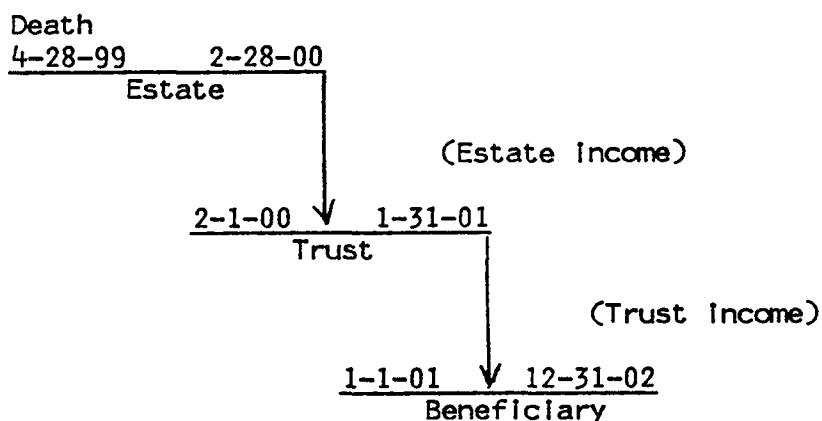
Mr. Clifford's Objectives

1. Retire from active personnel management of real estate within eight years (assuming Clifford is currently 57 years old).
2. Estate should go to spouse, and then in equal parts to children.
3. Estate should not pass real estate that requires management to spouse or children.
4. Maximize spendable cash without running risk of outliving income.
5. Create liquid reserves sufficient to pay estate, inheritance, and income taxes.
6. Estate should provide income sufficient to allow Clifford's spouse to continue living the lifestyle she has grown accustomed to.
7. Provide employment and retirement security for his secretary and foreman.
8. Reduce income taxes.
9. Bequest of \$500,000 to the University of Wisconsin to endow a real estate chair.

APPENDIX 7

The use of varied fiscal years for the trust and the estate can permit the recognition of tax liabilities to be deferred for a significant period because each beneficiary, whether a trust or an individual, is not deemed to have received the income distribution until the close of the distributor's taxable year. For example, a deferral can be set up if the estate adopts a February 28 year-end and the trust adopts a January 31 year-end. In this respect, the tax on the income realized by the estate through February 28, 2000, should be deferred until the individual beneficiaries report such income on April 15, 2003.

This is illustrated by the following diagram.



Clifford Case Part II

Estate Plan for Clifford Estate

Business 850

Steve Rasmussen

4/16/86



Introduction

My initial analysis of the Clifford estate revealed some glaring weaknesses. Mr. Clifford's real estate portfolio, representing the bulk of his estate, has been largely depreciated to a point where his mortgage principal payments are greater than his depreciation deductions. This lack of tax shelter has produced an after-tax income of only \$126,150 on before-tax income of \$280,333. In addition to losing the bulk of his income to the government, Mr. Clifford has no logical plan for transferring his wealth to heirs. His estate is largely illiquid and would be seriously diluted by capital gains tax and estate tax. This analysis attempts to lay out a sentient estate plan for the Clifford estate.

Goals

The first step in any estate plan is to clearly define the client's objectives. Mr. Clifford has 6 major goals and numerous subgoals to help him achieve his major goals.

1. Increase Wealth Transferable
 - a. capital gains tax avoidance
 - b. estate tax avoidance
2. Facilitate Ease of Wealth Transfer
 - a. greater liquidity of assets
 - b. allocation of estate (will)
 - c. transition from active to passive management
3. Increase Cash Flow Retained
 - a. tax shelter
 - b. lower tax rate
4. Security -- Lifetime Income
5. Employment & Retirement Security for Secretary
6. Endow \$500,000 Chair of Real Estate at University of Wisconsin

Estate Plan

An estate planning containing 14 major points has been developed to help Mr. Clifford realize his objectives.

#1 -- Make \$40,00 improvements to Clifford Building

Although this doesn't sound like a critical point, it is imperative for the rest of the plan that Mr. Clifford put the Clifford Building into condition for leasing.

#2 -- Lease the Clifford Building to satisfactory tenants

Again, nothing earth shattering here. However, in order to refinance, it is necessary to have satisfactory tenants.

#3 -- Refinance real estate portfolio with blanket mortgage

With all properties leased to satisfactory tenants, Mr. Clifford should be able to pull \$1,797,747 tax-free dollars out of his properties by refinancing. A 67% LTV, 10%, 15 year term blanket mortgage would yield \$1,717,362 on Clifford's \$2,562,400 real estate portfolio. After retiring the outstanding balance on the Industrial Park LO, Clifford would have approximately \$1.3 million dollars to invest.

#4 -- Invest \$1,797,747 in diversified portfolio of long term municipal bonds with 11% coupon.

This would give Clifford an annual tax-exempt dividend of \$197,752. Since these will go to his estate, Clifford should not be concerned about substantial capital loss in the event interest rates rise precipitously. He and his wife would have a secure lifetime income locked in, and any capital loss would merely reduce estate taxes.

#5 -- Incorporate real estate portfolio into Clifford Corp.

With his \$744,618 equity in his real estate portfolio after refinancing, Clifford should form a corporation. He and Mrs. Clifford would receive \$704,618 of preferred stock, and they could gift \$240,000 of common stock to their sons. The Clifford could separately gift \$60,000 to each of their sons. Therefore, each son would receive \$120,000 of common stock. By gifting separately, the Cliffords can take full advantage of their gift tax exemptions: \$50,000 lifetime personal exemption + \$10,000 annual exemption. Only the preferred stock would receive dividends, and the common stock would have an option to purchase the preferred stock at the face value of \$704,618 at the end of 8 years. In this way, Mr. and Mrs. Clifford can receive nominal dividends over the next 8 years and avoid capital gains. Their sons would receive a major transfer of wealth at low capital gains rates. As we shall see, the corporate form has many other advantages for Clifford. Mr. Clifford would continue overseeing his portfolio until his retirement in 8 years as president of the company. During this time he could arrange for the orderly sale of the real estate assets.

#6 -- Clifford sells \$200,000 bond portfolio for a \$50,000 long term loss, which produces a \$25,000 deduction to this year's income.

#7 -- Clifford can lend this \$200,000 to the corporation at 8% interest, accumulating over 8 years

With the interest accumulating, the corporation can deduct the interest expense with accrual accounting even though it has no cash outlay. The total balance of \$370,186 will be payable in 8 years.

#8 -- Clifford Corp. can in turn invest the \$200,000 in a REIT with a 10% dividend, appreciating 3% annually.

#9 -- Set up pension plan for secretary

The corporate plan is a good format to achieve retirement security for Clifford's secretary. If \$11,167 is funded annually and earns 10%, when the secretary retires in 8 years at age 65, she will receive a \$12,000 annual annuity for the next 20 years.

Exhibit 1 shows the forecasted income statements for the Clifford Corporation. It shows many of the points covered up to this point.

#10 -- Corporation is to be liquidated at the end of 8 years

At this time, the assets can be sold and the Cliffords and their children can cash out. Exhibit 2 shows a worksheet for the estimated proceeds of this sale. The children enjoy a substantial increase in wealth due to the sale.

EXHIBIT 1
FORECASTED INCOME STATEMENTS FOR CLIFFORD CORP.

	Yr. 1	Yr. 5	Yr. 8
Real Estate Income			
Gross Rent [1]	\$572,500	\$725,226	\$725,226
Vacancy	45,800	58,018	58,018
Expenses [2]	240,450	304,595	304,595
NOI	\$286,250	\$362,613	\$362,613
Depreciation	33,889	26,586	26,586
Interest [3]	191,786	163,772	134,519
Real Estate Income	\$60,575	\$172,255	\$201,508
Other Income			
Investment Income [4]	20,000	23,185	25,335
Total Income	\$80,575	\$195,440	\$226,843
Expenses			
Bond Interest [5]	16,000	20,155	29,614
Employee Pension [6]	11,167	11,167	11,167
Officer Salary	15,000	15,000	15,000
	42,167	46,322	55,781
Net Inc. B/4 Taxes	\$38,408	\$149,118	\$171,062
Taxes	9,948	78,698	92,202
Net Inc.	\$28,460	\$70,420	\$78,860
Preferred Stock Div.	\$1,986	\$8,629	\$0
Retained Earnings	\$26,474	\$61,791	\$78,860

Notes:

- [1] 4 yr. fixed rent leases, market rents increasing 3%/yr, renewed at market
- [2] pass-through of expense increases during lease term
- [3] \$1,917,862 blanket mortgage, 10%, 15 yr. term
- [4] investment in REIT with 10% dividend and 3% annual appreciation
- [5] 8% coupon with interest accruing -- principal and interest due in 8 yrs.
- [6] pension plan for secretary --

Assumptions: retires in 8 yrs at age 65;
will receive \$15,000/yr for next 20 yrs;
pension fund earns 10%/year

EXHIBIT 2

SALE OF CLIFFORD CORP. IN YEAR 8

Inflows				

Sale of Real Estate				
Sales Price	\$3,771,190			
Selling Expense	(188,559)			

Amount Realized	3,582,621	\$3,582,621		
Adjusted Basis	(444,104)			

Total Gain	3,138,517			
	x .28			

Capital Gains Tax	(878,785)	(878,785)		
Mortgage Balance		(1,227,565)	\$1,476,271	

Sale of REIT Shares				
Sales Price	\$253,354	\$253,354		
Basis	(200,000)			

Gain	53,354			
	x .28			

Capital Gains Tax	(14,939)	(14,939)	238,415	
		-----	-----	
Total Inflow			\$1,714,686	
Outflows				

Retirement of Bond		(370,186)		
Purchase of Preferred Stock		(704,618)		

Value of Common Stock		639,882	\$639,882	
Basis		(240,000)		

Long Term Gain		399,882		
		x .28		

Capital Gains Tax		(111,967)	(111,967)	

Realized Amount After Tax			\$527,915	---> \$263,958/sdn

#11 -- Clifford will place his life insurance policy in an irrevocable life insurance trust at age 65.

At age 65, Clifford will have finished paying premiums on his policy. By placing the policy in the trust, Clifford can avoid having it included in his gross estate because he has no incidents of ownership. By naming his sons as beneficiaries, he can then transfer \$300,000 tax-free. Clifford need not name his wife as beneficiary since she will be financially secure without the insurance proceeds.

#12 -- Clifford's will should specify that upon his death, \$500,000 is to go to the University of Wisconsin

This gift has the advantage of being exempt from estate taxes.

#13 -- For the remainder of his estate, Clifford's will should specify that \$500,000 go into a Bypass Trust and the remainder into a Q-Tip Trust.

In this way, Clifford avoids estate tax on his portion of estate both at his death and at Mrs. Clifford's death. Mrs. Clifford will receive a lifetime interest and the boys will receive the remainder upon her death. The Bypass Trust takes advantage of Clifford's allowable exemption, and the Q-Tip Trust takes advantage of the unlimited marital exemption.

#14 -- At end of year 8, the Cliffords will take advantage of their one time \$125,000 residence exemption. They can sell their home, which will be valued at approximately \$100,000, and buy a new townhouse closer to their two sons. With their exemption, they can avoid paying substantial capital gains tax.

Exhibits 3 and 4 show the favorable impact these changes have on both the Clifford's personal income and their estate tax exposure. Their after-tax income is doubled, and their estate tax is nominal.

EXHIBIT 3
ESTIMATE OF CLIFFORD'S PERSONAL INCOME

	YR 1		YR 5		YR 8	
Income						
Muni Tax-Exempts	\$197,752		\$197,752		\$197,752	
Common Stock Div	20,600		23,185		25,335	
Preferred Stock Div	1,986		8,629		0	
Salary	15,000		15,000		15,000	
Misc. Income	10,000		10,000		10,000	
Interest from Loan to Corp.	0		0		170,186	
Total Income	245,338	\$245,338	254,566	\$254,566	418,273	\$418,273
Exemptions						
Deduction	(10,000)		(10,000)		(10,000)	
Tax-Exempts	(197,752)		(197,752)		(197,752)	
Long-Term Bond Loss	(25,000)		0		0	
Taxable Income	12,586		46,814		210,521	
Blended Rate	x .2289		x .394		x .55	
Tax	(2,881)	(2,881)	(18,428)	(18,428)	(115,787)	(115,787)
Income After Taxes		\$242,457		\$236,138		\$302,486

EXHIBIT 4

ESTATE TAX CALCULATIONS

Mr. Clifford's Death		Mrs. Clifford's Death	
Tax-Exempts	\$2,702,365		\$1,351,183
Common Stock	734,267		425,608
Townhouse	127,520		73,915
Personal Property	58,741		34,048
Cash in Bank	25,000		12,000
	<u>3,647,893</u>		<u>1,896,754</u>
Mr. Clifford has		Federal Estate Tax:	
50% interest in		555,800(.18)	100,044
these assets	x .50	.45(1,896,754-1,500,000)	178,539
	<u>1,823,947</u>		<u>278,583</u>
Exemptions:		Tax Credit	(155,800)
Endowment to UW	(500,000)		<u>122,783</u>
\$500,000 Exemption into			(122,783)
Bypass Trust	(500,000)		
Marital exemption into			\$1,773,971 -->\$886,986/son
Q-Tip Trust	(823,947)	State Inheritance Tax Per Son:	
	<u></u>	50,000(.075)	3,750
Estate Taxes	\$0	400,000(.10)	40,000
		386,986(.125)	48,373
			<u>92,123 x 2</u>
Pass to Children Tax-Free:			(184,246)
Life Insurance Benefits	\$300,000		
Bypass Trust		Amount Passed to Children	\$1,589,725
(when mother dies)	500,000		
Q-Tip Trust			
(when mother dies)	823,947		
	<u>\$1,623,947</u>	Total Taxes Paid = \$307,029	

Notes:

Mr. Clifford is assumed to die at age 70

Mrs. Clifford is assumed to die 5 yrs after Mr. Clifford

MR. CLIFFORD CASE PART II
Financial and Estate Planning .

Kevin M. Coffey
Real Estate Equity Investment
Course 850
April 16, 1986

Ex. 11

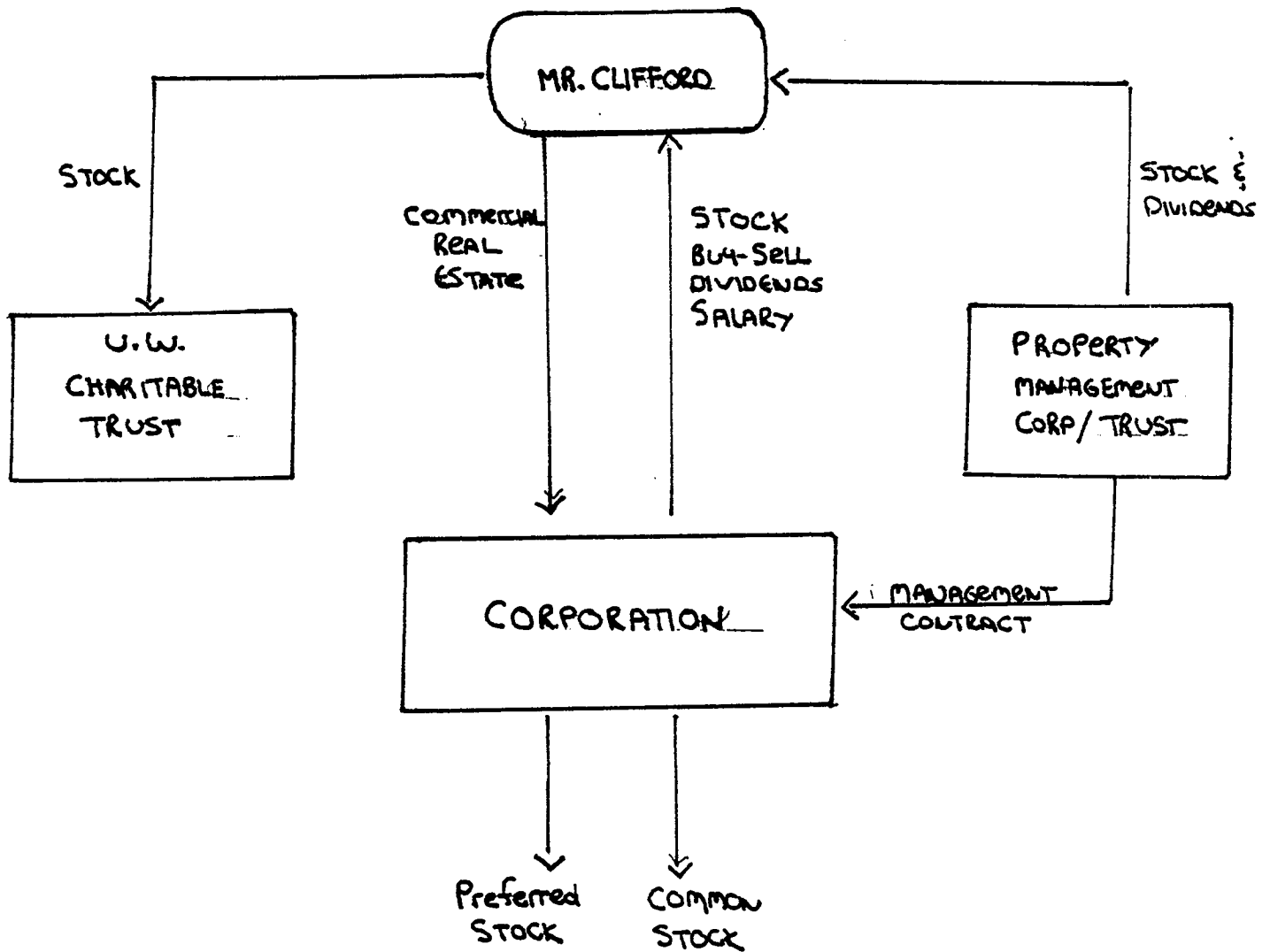
I. SUMMARY OF MR. CLIFFORD'S ESTATE PLAN

Mr. Clifford's financial and estate planning goals were outlined in Part I of the case. In order to best achieve these goals I have structured the following estate plan:

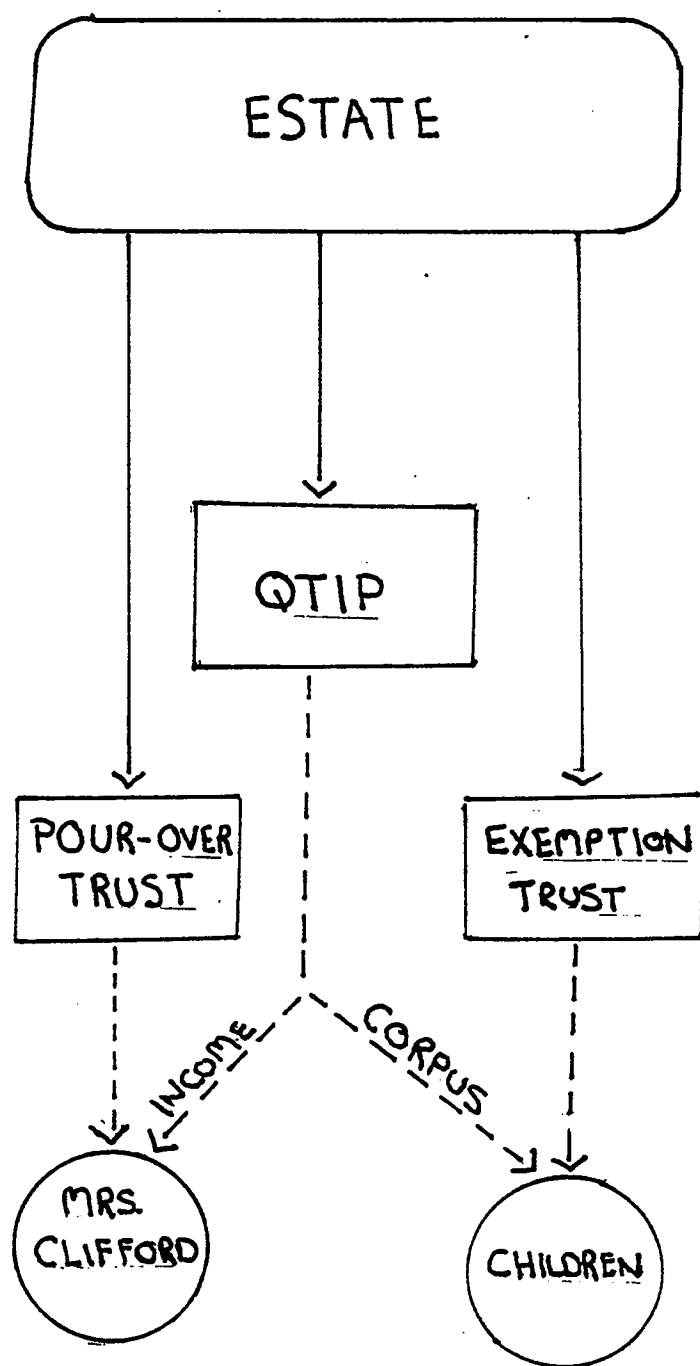
- (1) establish a corporation to hold Mr. Clifford's real estate holdings and shelter income.
- (2) have the corporation issue both preferred and common stock to freeze estate valuation.
- (3) Provide a Buy-Sell Agreement, pension fund benefits and Key-Man life insurance through the corporation.
- (4) Establish a Charitable Remainder Unitrust for the benefit of the U.W. Real Estate Program.
- (5) Establish a property management trust or corporation to provide an orderly transition of management of the real estate upon Mr. Clifford's retirement or death.
- (6) annual gifts of stock will be made to the children to reduce the estate taxes payable on the deaths of Mr. and Mrs. Clifford.
- (7) upon the death of Mr. Clifford estate taxes will be minimized and administrative ease will be maximized through the use of the Marital Deduction, and the establishment of a QTIP, Exemption Equivalent and Pour-over trusts.
- (8) provide for Mrs. Clifford's income needs upon Mr. Clifford's death through the trusts mentioned above.
- (9) provide estate liquidity through the Buy-Sell Agreement and life insurance proceeds.

This structure is illustrated in Exhibits 1 & 2 below

LIFETIME PLANNING



DEATH PLANNING



II. FINANCIAL PLANNING RECOMMENDATIONS

A. Incorporating the Family Business

Mr. Clifford's first step will be to structure a tax free incorporation of his commercial real estate holdings, under Section 351 of the Internal Revenue Code (hereafter I.R.C.). Appendix 1 summarizes the advantages and disadvantages of incorporation as discussed below.

1. Nontax Reasons for Incorporation

Formation of the corporation has the advantage of limited liability for shareholders, while allowing for centralized management. This is ideal for Mr. Clifford, since he will be both president of the corporation and controlling shareholder.

The corporation has a perpetual existence, and thus provides a method to allow Mr. Clifford's business to survive his retirement and death.

2. Tax Advantages of Incorporation

The primary income tax advantage to incorporation is that, as controlling shareholder and president, Mr. Clifford will be able to control receipt of income from the corporation in the form of salary and dividends.

Income not received by Mr. Clifford as salary or dividends accumulates in the corporation, and is taxed at lower corporate tax rates. The first \$25,000 of corporate income is taxed at 15%, whereas Mr. Clifford is currently in a 50% marginal tax bracket. The top marginal tax rate of 46% for corporations is also less than Mr. Clifford's current marginal tax rate.

A further tax advantage is that when the stock of the corporation is sold or the corporation is liquidated, all of the gain is taxable as capital gain rather than ordinary income. Thus incorporation provides a method to convert ordinary income to capital gain.

Another significant advantage is that Mr. Clifford can use a transfer of corporate stock to redirect wealth to his children or other beneficiaries, such as the U.W. Real Estate Program Charitable Trust.

An incidental advantage of doing business through a corporation is that all ordinary and necessary expenses of a corporation are automatically deductible under I.R.C. Section 162, since all are assumed to be business expenses. Many deductions of an individual are limited by I.R.C. Sections 162, 165 and 262 (relating to nonbusiness expenses), under which Mr. Clifford must show a reasonable relationship between the expense and a profit motive.

Certain fringe benefits, such as paid vacations, health and accident plans, group insurance and medical benefits will be available to the corporation which would not be available to sole proprietorships, partnerships and other forms of doing business.

A major benefit available through incorporation is a corporate pension plan. The corporation will be able to establish a pension plan for the benefit of Mr. Clifford, his secretary and other employees. This will be discussed in detail in a later section of this paper.

3. Tax Disadvantages of Incorporation

The principle disadvantage to incorporation is that of double taxation, whereby a tax is incurred by the corporation, and a second tax arises when income is passed through to shareholders in the form of dividends.

Mr. Clifford will be able to mitigate this somewhat in that he can manipulate his salary level as majority shareholder. Since his salary is deductible by the corporation it is not subject to double taxation. However, upon retirement Mr. Clifford will no longer be paid a salary, and thus the earnings will be subject to a double tax.

As president of the corporation Mr. Clifford will also be able to manipulate the level of dividends declared by the corporation, thereby mitigating the effect of double taxation.

However, the ability to defer dividends and accumulate income within the corporation is limited by I.R.C. Section 531, which provides for the imposition of an additional tax where a corporation is formed for the purpose of avoiding income taxes, and where it unreasonably accumulates income. This problem is discussed in detail at Appendix 2.

When using a closely held corporation, care must be taken that its income is not deemed to be Personal Holding Company Income within the meaning of I.R.C. Section 543. A substantial penalty tax arises if the code section applies. See Appendix 5 for a detailed discussion of this problem.

Incorporation provides a substantial business advantage, in the sense that Mr. Clifford's personal assets are not at risk of the corporate business activities. However, there is a corresponding tax disadvantage. Mr. Clifford's individual losses are not available to reduce corporate gains, and vice-versa. Crossover of gains and losses is precluded.

Since Mr. Clifford will be transferring assets into the corporation which have an extremely low basis, the corporation will be liable for the capital gain if the assets are sold in the ordinary course of business.

Corporations, unlike individuals, are unable to take advantage of the special 60% capital gain deduction provided under I.R.C. Section 1201(a). In addition, when the corporate gain is passed through to Mr. Clifford in the form of dividends it will be taxed as ordinary income. This is a significant disadvantage, and thus Mr. Clifford should only transfer assets into the corporation which he does not plan to sell until the corporation is dissolved.

If Mr. Clifford is not satisfied with the long term potential of his current real estate holdings he should consider exchanging for more appropriate real estate under the tax free exchange provisions of I.R.C. Section 1231.

If leverage was used in the tax free exchange Mr. Clifford could increase the taxable basis of the real property holdings, and thereby increase depreciation deductions to offset corporate income. This would then solve the problem of principal payments exceeding depreciation which Mr. Clifford presently faces.

If Mr. Clifford loses money in his current business he is entitled to an ordinary loss under I.R.C. Section 165(a),(c). However, if Mr. Clifford lends money to the corporation and

loses it, he has only a capital loss, which is not deductible against ordinary income (I.R.C. Section 165(g).). Thus, Mr. Clifford must be very careful to obtain only nonrecourse debt on corporate real estate holdings, and should not make personal loans to the corporation unless absolutely necessary.

There is a danger that the I.R.S. may challenge Mr. Clifford's incorporation under the "collapsible corporation" doctrine. See Appendix 4 for a detailed discussion .

4. Corporate Deferred Compensation Plan

Substantial tax savings can be achieved through the adoption of a corporate pension or profit sharing plan which qualifies under I.R.C. Section 401. Three general advantages result:

- (1) the corporation may deduct contributions to the plan as ordinary and necessary expense in the year the contribution is made.
- (2) the amount contributed with respect to each employee is not considered income to the employee in the year it is contributed. Taxation is delayed until retirement.
- (3) as the money accumulates in the fund the fund itself will make investments. Income from such investments is normally exempt from taxation under I.R.C. Section 501.

Thus, the corporate form will allow Mr. Clifford to establish a significant pension fund to provide for his retirement needs.

The tax law regarding the formation, contribution and distribution of pension funds is complex. Appendix 3 discusses some of the major factors Mr. Clifford should consider and the type of plan I recommend. I have structured Mr. Clifford's plan to provide for an annual contribution of \$75,000.

5. Stock Split to Freeze Estate Value

Upon formation the corporation will issue two types of stock: voting preferred and non-voting common. Thus, for valuation purposes the fair market value of the real estate in the corporation will be divided between the two classes of stock.

The value of the preferred stock will be set at the amount necessary to fund estate taxes and other liquidity needs (see financial analysis at end of paper). The effect is to "freeze" the value of the preferred stock, so that a subsequent gift of the common stock does not have a great value for tax purposes.

Through this technique, Mr. Clifford can transfer the future appreciation of the real estate holdings to other beneficiaries at a small gift tax cost. This transferred appreciation will then not be included in his estate for tax purposes.

Only the preferred stock will have voting rights. Thus, Mr. Clifford can gift his common stock without relinquishing management control of the corporation.

6. The Buy-Sell Agreement

In order to ensure that Mr. Clifford's estate has sufficient funds to pay estate taxes the corporation and Mr. Clifford will enter into a Buy-Sell Agreement, under which the corporation will be obligated to purchase Mr. Clifford's preferred stock upon his death. The advantages of this agreement are:

- (1) the value of the preferred stock is frozen for estate tax valuation purposes, and therefore presents no valuation problems upon Mr. Clifford's death.
- (2) accumulation of corporate earnings to fund Buy-Sell Agreements is considered a "legitimate business purpose", and therefore do not count against the \$250,000 accumulated earnings limitation discussed in Appendix 2.

The Buy-Sell provides a method to shelter accumulated corporate earnings and provide estate liquidity.

7. Key Man Life Insurance

Per the financial projections attached in the appendix Mr. Clifford will be able to count on accumulated corporate earnings to fund much of the Buy-Sell Agreement. However, if Mr. Clifford were to die soon after corporate formation no accumulated earnings would be available. Therefore, it will be necessary to obtain a key-man life insurance policy to protect against this risk.

The corporation will purchase a life insurance policy on Mr. Clifford's life with itself as the beneficiary. Upon Mr. Clifford's death the corporation will be obligated to use the policy proceeds to fund the Buy-Sell Agreement.

A tax advantage to key-man life insurance is that premiums are not taxable to Mr. Clifford as dividends per Revenue Ruling 59-184, 1959 C.B. 65.

A tax disadvantage is that payment of life insurance premiums on the lives of shareholders is not deductible by the corporation as a business expense per I.R.C. Section 264(a)(1).

Between the insurance policy and the accumulation of earnings the corporation will have sufficient capital to fund the Buy-Sell Agreement.

8. Management Contract to Provide Employment Security

To ensure employment security Mr. Clifford will enter into an employment contract with the corporation guaranteeing an annual salary of \$75,000 per year for presiding over the corporation as president.

One of Mr. Clifford's goals is to provide employment security for his secretary. He may do this by providing an employment contract for his secretary, for whatever term and salary both agree upon.

9. Annual Gifting of Stock to Children

Under ERTA each individual taxpayer is entitled to an annual gift tax exclusion for the first \$10,000 of gifts made to any one person. Married couples may exclude \$20,000 of gifts made to any one person.

In order to reduce the value of Mr. Clifford's taxable estate Mr. Clifford and Mrs. Clifford will donate \$20,000 of corporate common stock to each of the children in each year. At the face value of the stock this reduces Mr. Cliffords taxable estate by \$40,000 each year. In actuality it also reduces the estate by the amount of the appreciation of the real estate holdings locked into the common stock through the common-preferred stock split previously discussed.

10. Gifting of Life Insurance Proceeds to Mrs. Clifford

Assuming Mr. Clifford is sufficiently confident that his marriage will not dissolve before his death, he will irrevocably name his wife as beneficiary of his life insurance policy. This will assure that the proceeds are not considered a part of his taxable estate upon his death.

11. Conversion of Stocks and Bonds into Tax Free Munincipal Bonds

Mr. Clifford is presently achieving extremely low after tax yields on his stock and bond portfolio. He should sell them and reinvest the proceeds in tax exempt munincipal bonds.

The capital gain on the sale of the stocks may be offset by the capital loss on the sale of the bonds, thereby reducing the tax cost of the sale.

12. Establishment of a Charitable Remainder Trust for the Benefit of the U.W. Real Estate Program

Mr. Clifford will establish a Charitable Remainder Unitrust to be funded with annual contributions of corporate preferred stock. For purposes of the financial analysis at the Appendix of this paper it is assumed that he will contribute \$75,000 per year for four years, and then contribute the remaining \$200,000 upon his death. When the last surviving spouse dies the U.W. Real Estate Program receives the badly needed \$500,000.

The above structure will entitle Mr. Clifford to an annual charitable deduction for the lifetime gifts. Mr. and Mrs. Clifford are also entitled to receive the income from the trust for their lifetimes.

The annual charitable deduction to which Mr. Clifford is entitled per the I.R.S. tables is shown at Appendix 7.

Through the use of the Charitable Remainder Unitrust Mr. Clifford removes the value of the donated stock from his estate and thus reduces estate taxes due at death.

III. UPON MR. CLIFFORDS RETIREMENT

1. Use of a Revocable Trust or Corporation to Provide Future Management for Mr Clifford's Real Estate Upon Retirement

A revocable inter-vivos trust, or a corporation (separate from the previous corporation established to own the real estate), will be established to provide professional property management upon Mr. Cliffords retirement. A property management contract will be drawn up between the corporation owning the real estate and the managing entity.

This will ensure that the property is efficiently managed during Mr. Cliffords retirement years. As sole shareholder or trustee Mr. Clifford will have ultimate control of the entity, and thus may make management changes during retirement if he so chooses.

Upon Mr. Cliffords retirement or death a successor corporate trustee will assume Mr. Cliffords management responsibilities. The trustee will be responsible for hiring competent property managers and monitoring their performance.

This structure will provide for a smooth transition to professional property management when Mr. Clifford becomes unavailable, incapable or unwilling to manage the real estate holdings.

2. Retirement Funds

Mr. Clifford will be entitled to receive the proceeds of his corporate pension fund (discussed previously) upon his retirement. Per the financial analysis in the Appendix of this paper these benefits will be substantial and should provide a strong base for retirement security.

The preferred stock will also be throwing off substantial dividends upon Mr. Cliffords retirement. In addition, his personal assets will be available for retirement income. The tax exempt municipal bonds will supplement the above sources with tax free income.

These sources will provide a strong financial base for Mr. Cliffords retirement needs. If an emergency arose the corporation could be liquidated and the real estate sold to provide additional funds.

IV. PROVISIONS AT DEATH

1. Will Provisions

Mr. Clifford needs to draw a will to provide for administration and distribution of his estate. I recommend that Mr. Clifford establish the following structure for his estate:

(1) A QTIP Trust will be established for the benefit of Mrs. Clifford. The QTIP will be funded with the tax free municipal bonds and the remaining corporate stock (after distributions discussed below). Mr. Clifford is free to determine who the ultimate beneficiaries of the trust will be upon Mrs. Cliffords death. Mr. Clifford must be certain that

the trust complies with the complex requirements of I.R.C. Section 2056 to ensure that the trust funds are not taxed in his estate. Mrs. Clifford will be entitled to trust income during her lifetime.

(2) An Exemption Equilient Trust will be established with assets worth \$600,000 (the Unified Credit Equilient Exemption for 1987 and thereafter). This ensures that the Marital Deduction bequest under the QTIP is not so large that Mr. Clifford fails to take advantage of the tax free step up in basis provided by the Unified Credit. Mr. Clifford is free to dispose of this property as he wishes, with his beneficiaries receiving the property with a full step up in basis. It can be assumed the property will be corporate stock passed to his children.

(3) The amount needed to increase the funding of the university bequest (if any) to \$500,000 will be paid from the estate into the Charitable Remainder Unitrust. Mr. Clifford will be entitled to an estate deduction for this contribution, while Mrs. Clifford will be entitled to receive trust income during her lifetime per the trust provisions.

(4) a pour-over trust will receive the remaining assets of the estate. This property will be passed to Mrs. Clifford per the trust provisions, and thus will be eligible for the Marital Deduction.

2. Disposition of Corporate Real Estate Holdings

Mrs. Clifford will receive the excess real estate cash flow through stock dividends during her lifetime should she survive Mr. Clifford. Upon her death the real estate holdings would be sold in an orderly fashion in order to remove all responsibility for management of the real estate from their children.

If Mr. Clifford felt strongly against retaining the real estate after his death it would be possible to have the corporation liquidate at his death and fund the estate trusts with the sales proceeds from real estate disposition.

3. Simultaneous Death

If Mrs. Clifford and Mr. Clifford should die simultaneously, a will provision will presume she survives and Mr. Clifford's will will be executed as above. She will be able to bear the estate tax burden through the sale of the bonds, as well as the liquidation of Mr. Clifford's pension interests.

V. EFFECTS OF MR. CLIFFORD'S ESTATE PLAN

A. Financial Calculations

The financial implications of Mr. Clifford's estate plan are analyzed in detail in the Appendix 7. The results and implications are discussed below.

B. Summary of Financial and Estate Planning Recommendations

The financial and estate plan developed above solves the goals and objectives of Mr. Clifford as determined in Part I of the ~~case~~ ^{case} assignment:

- (1) Mr. Clifford's taxable income is reduced from \$124,230 to \$11,449 for the years 1986 through 1991.
- (2) Mr. Clifford's spendible cash after tax is more than sufficient to meet his personal living expenses. (\$72,355 in 1986)
- (3) corporate formation allows accumulated earnings to remain in the corporate shell and therefore be taxed at more favorable corporate tax rates.
- (4) real estate holdings are incorporated to provide a flexible and efficient transfer of real estate operations upon Mr. Clifford's death.
- (5) upon Mr. Clifford's death the income needs of Mrs. Clifford are provided for through the QTIP, Exemption Equivalent and Pour Over trusts.
- (6) Mrs. Clifford and her sons are not burdened with management of the real estate holdings after Mr. Clifford's death.
- (7) annual gifting of corporate stock to the children reduces the estate tax liability of Mr. and Mrs. Clifford.
- (8) appreciation of real estate assets is removed from the estate through the preferred-common stock split.
- (9) Mr. Clifford's estate tax liability is reduced to \$0 from \$1,628,000 through the use of the marital deduction.
- (10) combined estate taxes of Mr. and Mrs. Clifford are reduced, thereby transferring a larger percentage of their assets to the children.
- (11) assets passed to the children by Mr. and Mrs. Clifford upon their deaths receive a full step up in basis, thereby avoiding capital gains tax

In sum, the estate plan accomplishes all of Mr. Clifford's goals of reduced taxation, passing assets in appreciated form, maintaining continuity of business, and providing for competent and motivated management after his retirement.

TABLE OF APPENDICES

- Appendix 1: Advantages and Disadvantages of a Corporate Shell
- Appendix 2: The Accumulated Earnings Tax Problem
- Appendix 3: Mr. Clifford's Deferred Compensation Plan
- Appendix 4: The Problem of the Collapsible Corporation Doctrine
- Appendix 5: The Personal Holding Company Rules
- Appendix 6: The Use of the Marital Deduction in Mr. Clifford's Estate
- Appendix 7: The Charitable Trust and Schedule of Annual Deductions
- Appendix 8: Financial Statements and Analysis
 - (1) The Corporation
 - (2) Mr. Clifford Income Statement
 - (3) Estate Tax Due on Mr. Clifford's Death

Appendix 1: Advantages and Disadvantages of a Corporate Shell

ADVANTAGES:

- (1) Lower initial tax rate than individual tax rates
- (2) Reduction of Mr. Cliffords taxable income
- (3) Vehicle to provide Pension Fund Benefits
- (4) Buy-Sell Agreement can be used as a funding vehicle
- (5) Freeze estate value through stock split
- (6) Provides a business structure which continues after Mr. Clifford's death.
- (7) Tax free liquidation is available
- (8) Ability to redirect income to Mr. Clifford's family.
- (9) Deductibility at corporate level of all ordinary and necessary business expenses.
- (10) Liberal fringe benefits are available

DISADVANTAGES:

- (1) No direct pass-through of tax benefits to Mr. Clifford
- (2) Double taxation when dividends are declared
- (3) Personal Holding Company rules must be considered
- (4) Collapsible Corporation exposure
- (5) Accumulated Earnings tax exposure
- (6) Carryover basis of depreciable assets transferred to the corporation by Mr. Clifford
- (7) Capital losses of the corporation are not deductible by shareholders
- (8) Unfavorable treatment of Capital Gains at the corporate level

Appendix 2: THE ACCUMULATED EARNINGS TAX PROBLEM

The Accumulated Earnings Tax is a penalty tax imposed upon corporations which accumulate earnings with a purpose to avoid taxes on shareholders. The rules and regulations of this tax are found in I.R.C. section 531.

The penalty tax, which is at the rate of 27.5% of the first \$100,000, and 38.5% of the amount over \$100,000, is imposed upon a base referred to as "accumulated taxable income".

The rules and regulations of the I.R.C. section are complex. However, the essence is that every corporation is permitted to accumulate a total surplus of \$250,000 of excess earnings before being required to distribute earnings to shareholders.

Thus, if Mr. Clifford were to allow corporate earnings to exceed \$250,000, the corporation would be subject to the penalty tax. Since Mr. Clifford's real estate holdings are not heavily debt burdened, and are cash flowing, this is a very real possibility.

Corporations may avoid the penalty tax by investing excess earnings in business assets, or if excess earnings are retained for "reasonable needs of the business" (I.R.C. section 537 regulations). Reasonable business needs are defined as (1) the reasonably anticipated needs of the business, (2) the § 303 redemption needs of the business, and (3) the excess business holding redemption needs of the business. (I.R.C. regs §1.537)

Since Mr. Clifford's business needs would be real estate related, he would be able to retain earnings above and beyond the \$250,000 ceiling in order to provide for anticipated upcoming real estate expenses, such as maintenance, repair, capital replacement, working capital reserves, ect.

Mr. Clifford could also avoid the penalty tax by having the corporation purchase additional real estate with the accumulated earnings. If the real estate was unleveraged and rapidly saleable then liquidity needs could be protected as well.

Appendix 3: MR. CLIFFORD'S DEFERRED COMPENSATION PLAN

A. PLAN REQUIREMENTS

The major requirements of Mr. Clifford's deferred compensation plan are fourfold:

- (1) the plan must be based on a definite, permanent, written program that is communicated to employees.
- (2) it must meet the participation, vesting and funding requirements established by ERISA.
- (3) it must not discriminate in favor of officers, shareholders, supervisors, or highly paid employees. (i.e., Mr. Clifford)
- (4) it must not be a subterfuge for the distribution of profits to shareholders. (i.e., Mr. Clifford)

B. TYPES OF DEFERRED COMPENSATION ARRANGEMENTS

Plans that qualify under I.R.C. sections 401-404 for favorable tax treatment are referred to as "qualified plans". There are three major types of these plans:

(1) Defined Benefit Plans

This is a plan which provides for the payment of definitely determinable benefits over a period of years, usually for life, after retirement.

Retirement benefits are based upon factors such as years of service rendered by the employee and compensation earned by the employee. Since Mr. Clifford is establishing the plan so late in his career this type of plan is not viable for providing for his retirement needs.

(2) Defined Contribution Plan

A defined contribution plan is one which provides for an individual account for each participant, and provides benefits based solely upon the amount contributed to each participants account

Thus, in comparison to a defined benefit plan, a participant in a defined contribution plan is not assured of a guaranteed level of income upon retirement. Rather, the benefit is based upon the amount of the contribution into the plan over the employment period.

(3) Money Purchase Pension Plan

This is a plan that provides a benefit based on the total amount of employer contributions in a participants account. A money purchase plan is considered a "pension plan" because the employer has an obligation under the terms of the plan to make contributions irrespective of profits, usually expressed as a percentage of the employee's salary.

C. RECOMMENDATION FOR MR. CLIFFORD'S PLAN

It is recommended that Mr. Clifford establish a "Money-purchase" pension plan. This plan offers the relative advantages of guaranteed annual contributions (in contrast to a defined benefit plan) which is based solely on Mr. Clifford's salary level (in contrast to a defined contribution plan). Since Mr. Clifford is receiving the highest salary level in the corporation he will likewise receive the largest pension fund contribution in the corporation.

D. LUMP SUM DISTRIBUTIONS AND 10 YEAR AVERAGING

Upon retirement Mr. Clifford will receive favorable tax treatment of his pension fund benefits through the "Lump Sum Distribution" and "10 Year Averaging" elections under the Internal Revenue Code. Under these rules the tax due on the distribution of the pension plan benefits are determined as if Mr. Clifford received the income over ten years, rather than in a single year, thereby reducing the effective marginal tax rate applied to the income received.

Appendix 4: THE PROBLEM OF THE "COLLAPSIBLE CORPORATION DOCTRINE"

Mr. Clifford's real estate assets have been incorporated in order to reduce ordinary income taxes and pass on the appreciated corporate assets to his heirs at a minimized tax cost. Although this accomplishes the goals given to us in this assignment, there is a danger that the I.R.S. may attempt to attack the incorporation under the Collapsible Corporation rules of I.R.C. §341.

The collapsible corporation provisions were enacted to close a loophole whereby taxpayers attempt to transform ordinary business profits into long term capital gain through incorporation. In our case this would occur if Mr. Clifford were to liquidate the corporation, and thereby effectively convert ordinary corporate income accumulated in the corporation into capital gain upon the liquidation.

The technicalities of §341 are complex and will not be examined here. The point is that Mr. Clifford must realize that his estate plan does result in risk of being challenged by the I.R.S.. In this particular instance Mr. Clifford will be required to operate his business for a substantial period of time (say 5-10 years) before he would be able to liquidate the corporation and obtain favorable capital gains treatment. Mr. Clifford must weigh this limitation against the benefits provided by the estate plan.

Appendix 5: THE PERSONAL HOLDING COMPANY RULES

In structuring an estate plan with the use of a corporation, one must be aware of the risk that the I.R.S. may attempt to recharacterize the corporation as a "personal holding company".

For a corporation to be characterized as a PHC more than 50% of its stock must be owned by 5 or fewer individuals, and at least 60% of the corporations adjusted ordinary gross income for a taxable year must be considered "PHC income".

Under I.R.C. 8543 a corporations "adjusted income from rents" is PHC income unless:

- (1) it constitutes 50% or more of the corporations adjusted ordinary gross income; and
- (2) dividends paid for the taxable year equal or exceed the amount by which its nonrent PHC income for that year exceeds 10% of its ordinary gross income.

The result of the above is that a corporation such as Mr. Clifford's, which is formed to engage predominantly in rental activities, may escape PHC status providing its nonrental income is either not substantial, or if it is, it is distributed and taxed in that year.

Thus the PHC rules represent a limitation upon the business activities which may be undertaken in Mr. Clifford's corporation. If the income were characterized as PHC income it is subject to a penalty tax of 70% of all income not distributed - a substantial penalty indeed.

Appendix 6: THE USE OF THE MARITAL DEDUCTION IN MR. CLIFFORD'S ESTATE

The estate plan proposed in this case makes use of the Marital Deduction to achieve significant tax savings, through the following mechanisms:

- (1) the ability to pass property to Mrs. Clifford on a tax free basis,
- (2) the ability to structure a QTIP trust for tax free transfer, while retaining the ability to name trust beneficiaries,
- (3) the ability to structure the will such that the net amount of assets passing to the children increases significantly.

It must be noted that the above are all tax orientated motivations. Although certain facts were not specified in our case, Mr. Clifford must consider the following items in deciding the extent to use the Marital Deduction:

- (1) Mr. Clifford may not be willing to place control of the Marital Deduction property in his wife.
- (2) whether Mrs. Clifford's estate is likely to increase by inheritance, or decrease through lifetime consumption and inter-vivos gifts.
- (3) the possible effects of future modifications in the tax laws.
- (4) the increase in probate and administrative expenses in Mrs. Clifford's estate may reduce the tax savings achieved through the use of the Marital Deduction upon Mr. Cliffords death.
- (5) the increase in Mrs. Clifford's income after Mr. Cliffords death may create adverse income tax consequences, which could reduce the anticipated estate tax savings.

Appendix 7: THE CHARITABLE TRUST AND SCHEDULE OF ANNUAL DEDUCTIONS

There are two types of Charitable Remainder Trusts afforded tax benefits under the Internal Revenue Code: Unitrusts and Annuity Trusts. The main difference is related to the determination of the amount of the annual payment the income beneficiary (Mr. Clifford) will receive. I.R.C. § 664 provides for more flexibility in payouts to a Unitrust, and therefore I have chosen that form.

When Mr. Clifford contributes \$75,000 to the trust each year from 1987 - 1990, he will be entitled to the following charitable contribution deductions, based upon the tables provided at I.R.C. Reg. 1.664-4 (attached):

Deductions for Annual Contribution with
5% Annual Distribution

<u>year</u>	<u>deduction</u>
1987	\$30,895
1988	\$31,886
1989	\$32,851
1990	\$33,849

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Table E—Continued. Table, Single Life, Unisex, Showing the Present Worth of the Remainder Interest in Property Transferred to a Unitrust Having the Adjusted Payout Rate Shown

(1) Age	(2) Adjusted Payout Rate									
	4.2%	4.4%	4.6%	4.8%	5.0%	5.2%	5.4%	5.6%	5.8%	6.0%
16	.11491	.10516	.09640	.08852	.08142	.07502	.06924	.05403	.05931	.05504
17	.11903	.10908	.10012	.09204	.08475	.07817	.07223	.06685	.06199	.05757
18	.12321	.11304	.10387	.09560	.08812	.08136	.07524	.06970	.06468	.06012
19	.12747	.11709	.10771	.09923	.09156	.08462	.07832	.07261	.06743	.06272
20	.13186	.12126	.11168	.10300	.09513	.08800	.08152	.07564	.07029	.06542
21	.13639	.12558	.11578	.10690	.09883	.09151	.08485	.07879	.07327	.06824
22	.14108	.13005	.12004	.11094	.10268	.09516	.08831	.08207	.07638	.07119
23	.14594	.13469	.12446	.11516	.10669	.09897	.09193	.08551	.07964	.07428
24	.15101	.13954	.12910	.11958	.11091	.10299	.09576	.08915	.08310	.07756
25	.15632	.14464	.13398	.12426	.11537	.10725	.09982	.09302	.08679	.08108
26	.16191	.15001	.13914	.12920	.12011	.11179	.10416	.09717	.09075	.08486
27	.16778	.15567	.14459	.13444	.12514	.11661	.10878	.10160	.09500	.08892
28	.17394	.16162	.15032	.13997	.13046	.12173	.11370	.10632	.09953	.09328
29	.18035	.16782	.15632	.14575	.13604	.12710	.11888	.11130	.10432	.09788
30	.18702	.17429	.16259	.15181	.14189	.13276	.12433	.11656	.10938	.10276
31	.19393	.18100	.16909	.15811	.14799	.13865	.13002	.12205	.11469	.10787
32	.20109	.18797	.17586	.16468	.15436	.14482	.13599	.12783	.12026	.11326
33	.20851	.19520	.18290	.17152	.16100	.15126	.14223	.13387	.12612	.11892
34	.21618	.20268	.19018	.17861	.16789	.15796	.14874	.14018	.13223	.12485
35	.22411	.21043	.19775	.18599	.17508	.16494	.15553	.14678	.13864	.13107
36	.23228	.21844	.20558	.19363	.18253	.17221	.16260	.15366	.14533	.13757
37	.24071	.22670	.21367	.20154	.19026	.17975	.16996	.16082	.15231	.14435
38	.24938	.23521	.22201	.20971	.19825	.18756	.17758	.16826	.15955	.15142
39	.25827	.24396	.23060	.21814	.20650	.19563	.18547	.17597	.16708	.15875
40	.26741	.25295	.23945	.22682	.21502	.20397	.19364	.18395	.17488	.16638
41	.27679	.26220	.24855	.23577	.22381	.21259	.20209	.19223	.18298	.17430
42	.28642	.27172	.25793	.24501	.23289	.22152	.21084	.20082	.19140	.18254
43	.29629	.28147	.26756	.25450	.24224	.23071	.21988	.20969	.20010	.19107
44	.30639	.29147	.27745	.26426	.25186	.24019	.22920	.21885	.20910	.19991
45	.31669	.30169	.28756	.27426	.26173	.24992	.23878	.22828	.21837	.20902
46	.32722	.31213	.29791	.28450	.27185	.25991	.24864	.23799	.22793	.21842
47	.33795	.32280	.30849	.29498	.28222	.27016	.25876	.24798	.23777	.22812
48	.34890	.33370	.31932	.30573	.29287	.28070	.26918	.25826	.24792	.23812
49	.36007	.34482	.33039	.31672	.30377	.29150	.27987	.26883	.25837	.24843
50	.37144	.35617	.34170	.32797	.31494	.30258	.29084	.27970	.26911	.25905
51	.38301	.36773	.35322	.33944	.32635	.31391	.30208	.29084	.28014	.26996
52	.39476	.37948	.36495	.35113	.33799	.32548	.31358	.30224	.29144	.28115
53	.40668	.39141	.37688	.36304	.34986	.33729	.32532	.31390	.30302	.29263
54	.41874	.40350	.38897	.37512	.36191	.34931	.33728	.32579	.31482	.30434
55	.43093	.41574	.40123	.38739	.37416	.36152	.34945	.33790	.32686	.31631
56	.44324	.42811	.41364	.39980	.38657	.37392	.36181	.35022	.33912	.32850
57	.45568	.44062	.42620	.41240	.39918	.38652	.37438	.36276	.35162	.34093
58	.46823	.45325	.43890	.42514	.41194	.39929	.38715	.37550	.36432	.35359
59	.48091	.46603	.45175	.43805	.42489	.41226	.40013	.38847	.37727	.36650
60	.49370	.47893	.46475	.45112	.43802	.42542	.41331	.40165	.39044	.37965
61	.50661	.49198	.47790	.46436	.45133	.43878	.42670	.41506	.40386	.39306
62	.51963	.50515	.49120	.47776	.46481	.45233	.44029	.42869	.41750	.40671
63	.53275	.51844	.50463	.49131	.47846	.46606	.45409	.44253	.43138	.42060
64	.54596	.53182	.51817	.50498	.49225	.47994	.46805	.45656	.44545	.43471
65	.55922	.54528	.53180	.51877	.50616	.49397	.48217	.47076	.45971	.44902
66	.57253	.55880	.54551	.53264	.52018	.50811	.49642	.48510	.47413	.46350
67	.58586	.57235	.55926	.54657	.53427	.52235	.51079	.49957	.48869	.47814
68	.59921	.58594	.57306	.56057	.54845	.53668	.52525	.51416	.50339	.49293
69	.61258	.59956	.58692	.57463	.56270	.55110	.53983	.52888	.51823	.50788
70	.62597	.61322	.60082	.58877	.57704	.56563	.55453	.54373	.53322	.52299
71	.63941	.62695	.61481	.60300	.59149	.58029	.56938	.55875	.54839	.53830
72	.65289	.64073	.62887	.61731	.60605	.59507	.58436	.57392	.56374	.55380
73	.66635	.65449	.64293	.63165	.62064	.60990	.59941	.58917	.57918	.56942
74	.67967	.66814	.65688	.64588	.63514	.62465	.61439	.60437	.59458	.58502
75	.69275	.68156	.67061	.65990	.64944	.63920	.62919	.61940	.60983	.60046
76	.70557	.69470	.68407	.67366	.66348	.65351	.64375	.63419	.62484	.61568
77	.71809	.70756	.69724	.68714	.67724	.66755	.65804	.64873	.63961	.63066
78	.73033	.72014	.71015	.70036	.69075	.68133	.67209	.66303	.65414	.64542
79	.74235	.73251	.72284	.71336	.70405	.69492	.68595	.67714	.66850	.66001
80	.74417	.74468	.73535	.72619	.71718	.70834	.69965	.69111	.68272	.67448
81	.76573	.75659	.74759	.73875	.73006	.72151	.71311	.70484	.69671	.68872
82	.77696	.76816	.75951	.75099	.74261	.73436	.72624	.71825	.71039	.70265

FINANCIAL STATEMENTS

THE CORPORATION

Years Ending December 31, 1986, 1991 & 1996

<u>INCOME</u>	<u>1986</u>	<u>1991</u>	<u>1996</u>
Rents (EGI)	\$526,700	\$526,700	\$526,700
Interest on accumulated Earnings	-	8,972	24,035
TOTAL INCOME	<u>\$526,700</u>	<u>\$535,672</u>	<u>\$550,735</u>
<u>EXPENSES</u>			
Real Estate Expenses	\$229,000	\$229,000	\$229,000
Depreciation (constant)	33,403	33,403	33,403
Interest	11,103	11,103	11,103
Wages:			
President	75,000	75,000	75,000
Secretary	20,000	20,000	20,000
Crew Chief	20,000	20,000	20,000
Corporate Trustee			52,670
Deferred Compensation Plan:			
President	75,000	75,000	
Secretary	20,000	20,000	
Crew Chief	20,000	20,000	
Key Man Life Insurance	10,000	10,000	10,000
TOTAL EXPENSES	<u>\$513,506</u>	<u>\$513,506</u>	<u>\$356,176</u>
NET INCOME	\$ 13,194	\$ 22,166	\$214,524
FEDERAL INCOME TAX DUE	\$1,979	\$3,324	\$98,681
ACCUMULATED EARNINGS	\$11,215	\$58,871	\$250,000
PREFERRED STOCK DIVIDENDS	-0-	-0-	\$115,563

CORPORATE FINANCIAL STATEMENT ASSUMPTIONS:

- (1) Income and Expense amounts from part I of the case
- (2) Rental income and operating expenses remain constant
- (3) No refinancing of real estate
- (4) Accumulated earnings in excess of \$250,000 are distributed to shareholders
- (5) Mr. Clifford receives annual salary of \$75,000
- (6) 7.5% interest on accumulated earnings
- (7) Corporate Trustee fees includes property management expense of 6% per year of EGI
- (8) Pension fund contributions approximate annual salaries

MR. CLIFFORD
INCOME STATEMENT

Years Ending December 31, 1986, 1991, 1996

	<u>1986</u>	<u>1991</u>	<u>1996</u>
<u>INCOME</u>			
Salary	\$75,000	\$75,000	\$ 75,000
Preferred Stock Dividends	-	-	115,563
Charitable Trust Deductions	(30,895)	-	-
Miscellaneous	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>
GROSS TAXABLE INCOME	\$54,105	\$85,000	\$125,563
Less: Standard Deduction	<u>(2,300)</u>	<u>(2,300)</u>	<u>(2,300)</u>
NET TAXABLE INCOME	\$51,805	\$82,700	\$123,563
 FEDERAL TAXES DUE	 \$ <u>11,449</u>	 \$ <u>28,442</u>	 \$ <u>48,612</u>
	\$40,355	\$54,258	\$ 74,623
Add: Tax Free Interest on Munincipal Bonds	<u>\$32,000</u>	<u>\$32,000</u>	<u>\$ 32,000</u>
SPENDIBLE CASH AFTER TAX	\$72,355	\$86,257	\$106,623

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Assumptions:

- (1) Corporate Flows from Previous Statement
- (2) Present Income Tax Rules
- (3) Salary per discussion in paper

ESTATE TAXES DUE UPON MR. CLIFFORD'S DEATH

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PROPERTY OWNED AT DEATH

FMV of Common Stock	\$1,250,000
Cash from Buy-Sell Agreement	500,000
Municipal Bonds	700,000
Cash in Banks	25,000
House (1/2 share)	40,000
TOTAL GROSS ESTATE	\$2,515,000
Less: Administrative/funeral expenses	(350,000)
Less: QTIP election/Marital Deduction	
Property	(1,565,000)
TOTAL TAXABLE ESTATE	<u>\$ 600,000</u>

ESTATE TAX LIABILITY	\$ 192,000
Less: Unified Credit	<u>(192,000)</u>
TOTAL TAXES DUE	<u>-0-</u>

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The Clifford Case

Part 2

Good job
excellent painting!!!

74
Jeanne Anderson
Business 850
Professor Graaskamp
April, 12, 1985

I. Mr. Clifford's Estate Planning Goals and His Present State of Affairs.

The following are Mr. Clifford's estate planning goals.

1. Reduce income taxes by at least 33%.
2. Have liquid reserves sufficient to pay state and inheritance taxes.
3. Leave a \$250,000 bequest to the UW Real Estate Chair.
4. Retire from active personal management of his real estate within 5 years.
5. Provide employment and retirement security for his secretary and crew foreman.
6. His estate is to go to his wife, and then in equal parts to his 2 children. They are to be provided for when and as appropriate.
7. For the balance of his life, he wants to maximize spendable cash without risking outliving his income.

Mr. Clifford's total net worth today is \$3,085,048. The details of this are taken from the Clifford case assignment, part 1, and are in table 1 of the appendix to this paper.

II. Basic Plan to Attain Objectives.

After considering many of the options available to Mr. Clifford, the following course of action is recommended. It meets all of his goals to a reasonable degree, it is relatively low risk, and it is quite practical and "doable".

<u>Time Frame</u>	<u>Action</u>	<u>Rationale/Goal</u>
Immediately, January, 1985	Mr Clifford is to have a will drawn up, giving his wife a qualified terminal interest, under the 1984 unlimited marital deduction, in all of his real and personal property, less \$250,000 in cash. Mrs. Clifford will receive all of the income produced by his estate, and upon her death, the estate is to be equally divided between their 2 sons.	Mr. Clifford leaves his estate to his wife and ensures that it passes to his sons upon his death.
Immediately, January, 1985	Mr. Clifford is to refinance all of his investment real estate holdings, at a 50% LVR, With this amount of equity still in the property, and because of his experience and reputation as A real estate entrepreneur, he should be able to obtain non-recourse financing. Under the current market conditions, he could obtain an 11.5% interest rate.	Mr. Clifford has a 3.89% return of spendable cash on B4 tax net worth; this is a step toward maximizing spendable cash.
February-March, 1985	The cash proceeds from the refinance are \$930,623. Mr. Clifford is to take this cash and invest it in low risk tax-free municipal bonds. Assuming a 7% return, this will provide an annual tax-free income of \$65,144.	Mr. Clifford is investing conservatively to ensure that he does not outlive his income.

Time Frame	Action	Rationale/Goal
February-April, 1985	Mr. Clifford is to form a corporation for the purpose of structuring and managing his real estate portfolio. Mr. Clifford is to give all investment real estate equity and debt to the corporation in return for 100 shares of preferred stock, which is to have a return of 6%. The corporation is to issue 100 shares of Class A common stock, with \$.01 per share, with voting privileges, and these are to be in Mr. Clifford's name. The corporation is also to issue 100 shares of Class B common stock, with \$.01 per share, and paying all dividends after the preferred return. Forty shares are to be in the names of each of his children, and twenty shares are to be held as treasury stock. Mr. Clifford is to be the CEO, and draw an annual salary of \$65,500.	Mr. Clifford retains the right to most of the current earnings of his real estate, to maximize his spendable cash. Mr. Clifford retains control of his assets. The salary contributes to Mr. Clifford's spendable cash.
May, 1985-April, 1988	The corporation is to begin execution of a 3 year plan to exchange its older, highly localized industrial space properties for 3 to 5 well-maintained and stable residential or office properties. These properties are to be diversified geographically to a limited degree, and by tenant type. All transactions will have to be structured to meet federal and state regulations to qualify as a "tax-free" exchange.¹ The 3 year plan is to be one of "exchanging up" to increase the value of the real estate holdings, and the depreciable basis. The new properties are to exceed the current equity of \$930,632 by \$2,171,453, giving total corporate real estate holdings of \$3,102,075. The acquisitions are to be financed with 30% equity and 70% non-recourse, self-amortizing debt at 11.5% for 15 years.²	The corporation convert its assets to more diversified income producing property. The increased diversification will provide greater income stability. The corporation increases its real estate value, and its depreciable base, which is useful to reduce income taxes. The corporation takes advantage of leverage to increase spendable cash.
May, 1985	The corporation is to enter into employment contracts with the secretary and the crew foreman. These contracts will guarantee employment under the appropriate terms for each party, until age 65 or until the corporation is dissolved, whichever occurs first. In either case, upon termination of employment, the employee will immediately begin to receive benefits from the corporate pension plan. The contracts are cancellable only by Mr. Clifford or the employee.	Mr. Clifford guarantee employment for his secretary and crew foreman.

¹ The Clifford building, although held for business use rather than investment, can be exchanged for investment property, per Pyhrr and Cooper, Real Estate Investment, p. 504.

² The optimal amounts of cash to be withdrawn by Mr. Clifford and the amount of real estate to be held by the corporation as well as the optimal debt amount were determined using MRCAP. See Table 2, Appendix.

<u>Time Frame</u>	<u>Action</u>	<u>Rationale/Goal</u>
May, 1985	The corporation is to establish a "defined benefits" pension plan, to include Mr. Clifford, his secretary, and his crew foreman, and any other designated employees. Benefits to Mr. Clifford are to begin in 1990, and are to be \$65,500 annually, the amount he now receives as salary.	The corporation provides retirement security for the employees. Mr. Clifford's spendable cash will be maintained upon his retirement.
May, 1986	Mr. Clifford is to begin efforts to locate a "key woman" (this is a very able variant of the "key man"; perhaps one of those talented UW grads) to assume the management responsibilities of the corporation and the real estate. To ensure that this person is appropriately involved and adequately motivated, the employment contract would specify the following compensation package: 1) Base salary of \$40,000 2) Starting in 1988, for the next 10 years, each year that investment targets are met she will receive 2 shares of class B common stock, and \$40,000 of preferred stock.	Mr. Clifford provides management continuity for himself and his heirs.
Immediately, January, 1985	Mr. Clifford's will is to include a \$250,000 cash bequest to the UW Real Estate Chair. The Class A voting common stock is to be divided equally among his 2 sons and his key man upon his and Mrs Clifford's deaths.	Mr. Clifford leaves \$250,000 to the UW Real Estate Chair. Mr. Clifford provides resolution of control questions; sons can exercise control, or not, and choose to dispose of property or not.

III. Evaluation of the Effectiveness of this Plan.

As stated earlier, this plan meets Mr. Clifford's goals to a reasonable degree, plus it is not dependent on any outside events after 1988. Results of particular interest are summarized below.

- 1) Initially, Mr. Clifford will own \$930,623 of preferred stock in the corporation. He will transfer \$400,000 of this to his key management person thus reducing his real estate ownership from \$1,980,048 to \$530,623.
- 2) Mr. Clifford's spendable cash has increased. Before the estate planning, his annual spendable cash was \$127,660. With the estate planning, by his retirement in 1990, his spendable cash is :

After tax corporate salary and dividends=	\$60,692
Municipal bond dividends, tax-free =	65,839
Other income and securities income =	35,875
	<u>\$162,406</u>

The spendable cash will remain quite constant, with the reduction of the preferred dividend as shares move the the manager offset by a slight increase in return on the property.

- 3) Income taxes decrease dramatically through the estate plan. Prior to the planning, income taxes were 42% of net income. Immediately after the plan is implemented, the income taxes fall to 14.5% of net income, and rise over 10 years to 29.9%.
- 4) As the only portion of Mr. Clifford's estate that is not in readily marketable form is the \$530,623 of preferred stock in his corporation, the need for liquid reserves for estate and inheritance taxes is not a problem.
- 5) After 1988, Mr. Clifford's assets are in low risk municipal bonds, life insurance, securities returning 6% after tax (from which one can infer low risk), and stock in his own corporation with a 6% preferred return. With the low risk level and the diversification, there is little risk that he will outlive his income.
- 6) He has effectively ensured capable management of the real estate holdings by making the key man a part owner. By the year 1993, this person owns \$200,000 or about 21% of the preferred stock, and 10% of the non-voting common stock. Five years later, this has reached 42% of the preferred and 20% of the commonstock, and ownership remains at this level.
- 7) Spendable cash is maximized in a number of ways.
 - A) Some of the yield from cash investments is tax-free.
 - B) No gifts are made that would reduce the investment base.
 - C) A corporate salary and dividends are paid from dollars sheltered through depreciation deductions.
 - D) Use of positive leverage for real estate investments increases spendable cash.
- 8) Mr. Clifford retains control through ownership of the class A voting stock. He can dispose of this at any time and in any manner. He provides for resolution of the control issue upon his (or his wife's) death by dividing the control amongst the three interest parties. At this time, any 2 of the 3 parties can decide to liquidate the real estate, or take any other appropriate steps.
- 9) With no estate planning, the value of the estate that would pass through to the heirs, after all estate and inheritance taxes would have been reduced by about 54%, from \$3,220,035 to \$1,511,328.¹ With this estate plan, the value to the heirs in 1995 will be;

A)	Increased value of 80 shares of common stock, not taxable as part of the estate	=	\$1,015,553
B)	Mr. Clifford's estate:		
	Securities	=	1,000,000
	Municipal Bonds	=	930,623
	Preferred Stock	=	530,623
	Other Assets	=	105,000
			2,566,246
	Estate and Inheritance Taxes	=	1,385,772
			1,180,474

¹ Based on 1985 values.

With the estate planning, the total value of the estate that would pass through to the heirs is \$2,196,027. this is an increase to the heirs of \$684,699, or 45%, and is accomplished at no cost and very minimal risk to Mr. Clifford..

Appendix

Table 1. Mr. Clifford's Position as of January 1, 1985.

	<u>Securities</u>	<u>Real Estate</u>	<u>Other</u>	<u>Total</u>
B4 Tax Net Worth	1,000,000	1,980,048	105,000	3,130,048
Income taxes	30,000	191,006	5,875	135,096
Spendable Cash	30,000	91,785	5,875	127,660

Table 2. Comparison of MRCAP Analysis of Real Estate Value and Debt Amount Options.

Scenario 1: Real Estate portfolio is not increased, and is refinanced at a 70% LVR.

	<u>1985</u>	<u>1990</u>	<u>1995</u>
Original R.E. Value	1,861,245		
Equity	558,373		
Cash to Mr Clifford	1,302,872		
Loan	1,302,872		
B4 Tax Net Worth	1,341,169	1,828,501	2,636,172
Income Taxes	51,934	75,047	113,663
Spendable Cash	26,370	33,417	36,519

Scenario 2: Mr. Clifford withdraws 60% of his equity, and uses the 40% remaining equity to increase real estate portfolio to a 70% LVR.

	<u>1985</u>	<u>1990</u>	<u>1995</u>
Original R.E. Value	2,481,660		
Equity	744,498		
Cash to Mr. Clifford	1,116,747		
Loan	1,737,162		
B4 Tax Net Worth	1,779,519	2,428,269	3,503,725
Income Taxes	57,429	88,200	139,621
Spendable Cash	46,110	55,453	59,516

Scenario 3: Mr. Clifford withdraws 50% of his equity, and uses the 50% remaining equity to increase the real estate portfolio to a 70% LVR. *

	<u>1985</u>	<u>1990</u>	<u>1995</u>
Original R.E. Value	3,102,075		
Equity	930,623		
Cash to Mr. Clifford	930,622		
Loan	2,171,453		
B4 Tax Net Worth	2,217,900	3,028,134	4,371,516
Income Taxes	62,296	101,357	165,591
Spendable Cash	65,839	77,474	82,492

* This scenario was judged best.

Cash flow output not included because it was not legible -

TRIBECA TOWERS CASE STUDY

Sept. 1, 1985

by Ralph Cram

What are the assumptions and hopes of Tribeca Towers project? Who will buy these units and at what price? Will the loan be repaid on a timely basis at the appropriate risk level? The framework of these questions, not the answers, focuses the project in terms of objectives and goals of Continental Illinois rather than that of the developer's. Within the context of Continentals' objectives, The loan should be brokered to a pension fund client as a convertible mortgage on a rental income property that will convert to luxury condominiums at a future date rather than as straight condominiums project. Market, locational, and personnel conditions warrant this conservative approach to such a pioneering project.

PROPERTY

Tribeca has no luxury apartments. The area's housing units is comprised mostly of renovated industrial lofts and office space. Its low density and artistic flavor has made it a growing alternative for Manhattan residents who want to live near work. While its population has doubled in the last ten years and the development of Battery Park City will create a broader residential base in lower Manhattan, market conditions today do not support a luxury condominium development in Tribeca. It must be remembered that condominium development is a series of shortruns; One longrun and we are all dead. Market conditions today do not support the assumptions made by Mr. Edwards. The assumptions that the market will continue to appreciate at 5% a year; that Mr. Edward's can sell condos at the same absorption rate, 14 per month, and price per square foot, \$340 per square foot, as projects in proven residential areas such as the Upper East Side; that today's buyers will still be in the market two years from now; that they will want to live in Tribeca; and that the project will be insulated from competition and have an competitive edge, are far too optimistic. The \$287 cost per square foot leaves very little room for spread in a market that has not seen above \$310 a square foot below 14th street.

With nearly four times as many luxury units in construction as built in 1984 and signs of a buyers market are appearing this summer. Who will buy Tribeca Towers' units and at what price? The current market for luxury condos in Manhattan consist of U.S. corporations, 30% to 40% of the market, speculators, 20% to 30%, U.S. owners, 20% to 30%, and foreigners, 6% to 15%. One third of luxury condos in New York City are secondary residence which are at political risk under federal tax reform proposal to limit interest deductions on second homes. The current slowing appreciation will cause speculators to drop out of the market, while a recession during the absorption period would cause a great reduction in corporate purchases. Buyers will expect a discount for buying units in this pioneering location; lower comparative prices is the prime cause for the residential boom in this area. The lack of public infrastructure in the area will cause family to look elsewhere. Also, Battery Park City will be in direct competition because of its mass, scale and amenities that Tribeca Towers cannot offer. The current marketing risk in the condominium market is unacceptably high.



The market risk of a luxury income property in Tribeca, in contrast, is low. The 1 1/2% vacancy level in the city, long waiting lists at other complexes, and a lower locational preference, has made Manhattan a strong landlord's market for uncontrolled units. The locational value of Tribeca Towers being near Wall Street will be higher as a rental property because tenants do not have the long range investment concerns of the condominium buyer. This locational advantage will give it a competitive edge over other luxury condominiums turned into rental properties. Also if built as a rental property, it would be one of the last all luxury unit projects under the 421a tax abatement program before new projects must have moderate income components to qualify for tax abatements. This factor will give it a short term advantage over new luxury rental projects. Yet the income from this property will not be able to support the conventional mortgage financing in today's market. Therefore a convertible mortgage format will be the preferred financing vehicle for this venture. The low vacancy level on the island and office space boom in lower Manhattan makes Tribeca Towers an excellent income property opportunity and long term residential trends in the area portend a lucid condominium conversion in the future.

PEOPLE & PACKAGE

There were two types of pioneers in the old west, speculators and homesteaders. Land speculators gambled on location and homesteaders bought value and held. It has been said a pioneer is the one who gets all the arrows. The same still holds true today for the urban pioneer. Our pioneer, Mr. Edwards, must be willing to be shoot at and boldly go forth into the urban wilderness of New York City and be rewarded for homesteading only when the project is completed. Therefore, Continental will broker a convertible mortgage that will finance 100% of a total fixed construction budget for Tribeca Towers guaranteed by a \$10 million letter of credit from the equity position with the last loan payment comprising 75% of the development fee and 100% of the land flip profit when the building is 85% occupied. The Towers will be converted to condominiums on a negotiated year and the mortgagor will back out with negotiated IRR hurdle level. Continental will service the loan and have first refusal on the conversion loan at the termination date. This leaves all the tax shelter, the land profit, development fees, property management fees, and any conversion residual on the table with the only budget and marketing risk bared by Mr. Edwards and company. This will meet the liquidity requirements of Mr. Edwards and allow him an entry to the New York market at limited financial risk. The completion of Battery Park City, the maturing of new construction in lower Manhattan, the proximity to the financial district and the improvement in public infrastructure in the area over the next ten years will cause the property to have above normal appreciation.

The high risk potential of luxury condominium development in Tribeca and the inadequacy of net income to cover a normal mortgage in the market today precluded any direct involvement with this project by Continental Illinois. We are confident that we can find a lender, probably a foreign pension fund, willing to enter in this type of arrangement. We also would be happy to assist Mr. Edwards in his search for financing for his four hotels in California.

FREMONT SHOPPING CENTER CASE

ORIGINAL ANALYSIS BY

MARY ANN HAYES

PREPARED FOR

PROFESSOR JAMES A. GRAASKAMP

AUGUST 1979

Evaluation of the information provided by the Bobandray Realty Investors regarding the Fremont shopping center and secondary information sources concerning retail sales and shopping center development indicate several investment flaws and risks associated with the property. Significant errors are discussed below.

1. The initial structures in the center were completed in 1962. Additional construction occurred between 1965-67, 1972 and 1977. This continued development could be interpreted as confidence in the center's ability to attract and sustain customers. However, two points discredit this theory. First, the center has had no competition from similar shopping centers. And second, it is located in Fremont's designated CBD with a master plan stressing development in the CBD area. Therefore, this may have been the only area for shopping center development.

2. The center is an open mall with one story construction, and each store has separate heating and air conditioning units. This is a positive factor in that it reduces the burden of utility cost increases on the center as a whole by passing them through to the store tenants. Stores are unified by a steel framed and paneled roof canopy extending across the store fronts, but the layout and use of different building materials suggests the concept of an integrated mall is not clearly visible. In addition, pedestrian and parking areas cross each other creating confusion and inconvenience. In the age of the enclosed mall, the center is facing functional obsolescence.

3. The age of the center has another problem besides functional obsolescence and that is constant

need for repair and replacement with construction ranging in age from 2 to 17 years. The shell has a useful economic life of 40 years, but mechanicals, ceilings, roofs, and parking areas have useful economic lives ranging from 5 to 10 years. Little information has been provided as to the provisions necessary to deal with this problem.

4. The financial statement indicates that since 1974 advertising and promotion for the center has either declined or remained constant. When viewed in light of the actual growth in sales that has occurred, this may be viewed as one of the center's important problems in boosting sales.

5. The tenant mix of 93 tenants is diverse, but has more of the character of a community center than that of a regional center. Within the portion of the center that is available for purchase, the major anchor tenant is a local department store and on the periphery are two regional chain supermarkets. This questions its viability as a regional shopping center.

6. One of the most significant problems concerning this center is that of the Wards store that is built into the center, but not under the center's control. The Wards store accounts for 30% of the center's total GLA. This is a problem because in recent years, Wards has slipped in national popularity behind Sears and Penneys as a national department store. Consequently any market adjustment by the Wards store is out of the realm of control of the rest of the center indicating a potential for problems.

7. To provide a more accurate picture of the center's actual growth in retail sales and its potential for growth, information was collected for the city of Fremont and Alameda county from Sales Management magazine. Contrary to the position put forth in the BARI report, growth in the area has taken place, but in recent years growth has not met earlier projections and has actually declined. This suggests that the center's trade area may be holding steady or declining rather than growing. The same information source also shows that sales per capita for the city of Fremont has been significantly below that of the county (about 15%). The market share attributable to the Fremont center based on total retail sales potential for its trade area indicates that its market share is averaging at 9.5%. Market share peaked in 1975 and has been declining.

TABLE 1

RETAIL SALES AND MARKET SHARE FOR FREMONT HUB

	1973	1974	1975	1976	1977	1978
Fremont Hub Sales	\$39,471,206	\$43,615,271	\$47,792,199	\$51,300,031	\$55,355,207	\$59,618,495
Fremont population	120,600	122,700	127,700	123,900	119,600	120,000
Fremont Retail Sales	\$264,233,600	\$288,766,000	\$307,546,000	\$330,061,000	\$350,958,000	\$367,534,000
Sales Per Capita	\$2,190	\$2,353	\$2,408	\$2,663	\$2,934	\$3,227
County Population	1,117,100	1,120,400	1,108,300	1,102,100	1,106,300	1,106,900
Trade Area Population	201,078	201,672	199,494	198,198	198,000	198,000
Sales Potential	\$440,360,820	\$474,534,216	\$480,381,552	\$527,801,274	\$580,932,000	\$630,295,200
Market Share	8.96%	9.19%	9.95%	9.72%	9.52%	9.28%

8. Using Sales Management projections from 1973-1982, the increase in both population and total retail sales has shown an increase at a decreasing rate. When inflation is considered the forecast is less than favorable. When considering the growth of sales for the Fremont center from 1972 to 1978, much of the increase can be attributed to expansion and inflation. Analysis indicates that each additional store added to the reporting stores in 1972 were estimated to contribute .5% of the total sales reported. Inflation was also considered, so as to reflect the actual growth in sales for the period. After considering new store additions and inflation, the actual increase in sales is 14.4% for the total period or 2.4% per year. When effective gross revenue is compared to sales for 1974 to 1978 period, it remains constant at 3.69% of reported sales.

TABLE 2
EFFECTIVE GROSS REVENUE TO SALES

1974	\$1,624,406	/	\$43,515,271	=	3.72%
1975	\$1,715,049	/	\$47,792,199	=	3.59%
1976	\$1,899,422	/	\$51,300,031	=	3.70%
1977	\$2,020,074	/	\$55,355,207	=	3.65%
1978	\$2,263,484	/	\$59,618,495	=	3.80%

Average				=	3.69%

9. Overage income plays a significant role in the center's profitability, but analysis of sales growth potential and new leasing arrangements indicate a possible decrease in overages paid by tenants. The significant overages paid by tenants as of 1977 were \$300,000 by Mervyn's Department Store, \$72,000 by Long's Drugs, \$50,000 by Fry's Market, and \$35,000 by Ledeens. The remaining overages paid by other stores were in much smaller amounts. New leases are currently changing to triple net leases and rent per sq. ft. of GLA is averaging from \$8 - 13 which is consistent with information provided by ULI's Shopping Center's Dollars and Cents. From 1979 to 1988 over the projected holding period, 83.86% of the center's GLA will turn over. As rents increase, the basic rent and more expenses are passed on to tenants. Tenants caught in a financial squeeze may reduce services or merchandise and/or reduce quality of repairs and maintenance causing a decline in the center's appeal to customers. It should be expected that overages will decrease as will tenant's ability to pay them and vacancies may increase.

10. The proposed new shopping mall could have a disastrous effect on the Fremont center if constructed in two ways. First, the increase in competition would reduce the market share for retail sales that are already projected to increase at a decreasing rate. Therefore, damaging the tenant's ability to stay solvent and pay rent and overages. Second, a new modern center with more nationally known stores could speed the obsolescence of this center and currently strong tenants may choose to leave when their leases expire.

A financial analysis was performed for the Fremont center considering three scenerios. All three scenerios

use a backdoor approach to determine investment value using three mortgages, a desired default ratio of 83%, and a before tax return of 7%. The first two scenerios use year two as a basis for the analysis.

The first and most optimistic scenerio assumes that the center can maintain its market share and no new center will be built.

The second scenerio assumes that the market share for the center will continue to decline at an established 2.5% per year (as mentioned earlier) and no new center will be built. This is a realistic scenerio for a situation where no new competition developes.

The third scenerio is realistic if the proposed center is built and becomes operational in 1982. In this scenerio, market share continues to decline until 1982 as in scenerio two. Thereafter, the new center captures 25% of the Fremont center's declining market share. This reduction in market share assumption is based on two points. First, increased competition and interest and excitement generated by a new center attracting customers. And secondly, the fact that between 1981 and 1983 146,800 sq. ft. or 35.7% of the Fremont center's GLA will turnover and tenants could be attracted to the new center when leases expire. This analysis is the same, except that year four (4) is used as a baisses in the analysis to reflect the impact of the new center.

Estimates for the center's income were developed from two (2) sources. First, the basic rent will rise to levels of \$8 - 13 per sq. ft. of GLA when leases are renewed following the schedule provided by BARI.

Secondly, the effective gross revenue is based on the projection of retail sales for the center with no new additions. Sales from 1979 to 1982 are based on a 47.9% increase in total retail sales from 12/31/77 through 12/31/82 for Alameda county by Sales Management's projections. Since total retail sales are increasing at a decreasing rate, a 40% increase from 1983 - 1988 was made. The market share information determined the Fremont center's sales, and the effective gross revenue was compared with basic rent with the remainder being assigned to overage income.

The expenses used are net expenses and are assumed to stay relatively constant due to the increase in triple net leases. They will increase at 1% per year.

Component breakdown for percent of investment value required for backdoor analysis and depreciation was based on information provided in the Coldwell Banker's Investment Analysis. Ordinarily, the 125% declining balance method of depreciation would be used, but it was found that the extra depreciation charges did not help the cash position and caused a 15% tax on excess depreciation in years when the cash flow was negative. Therefore, straight line depreciation was used to avoid the tax and improving the cash flow.

The land is valued at 3 million. This figure was based on cost per sq. ft. of GLA for land as given in the ULI's Shopping Center Development Handbook for 1975. The cost was raised to reflect inflation and was assumed to be in the upper range of the values provided. The land could be sold with a leaseback arrangement, but considering the age of the center and its location in the bay area, the land may have the future potential of a heigher economic use.

The Fremont center is currently encumbered with six mortgages and annual debt service of \$490,588. In the financial analysis, the first two mortgages were assumed and the remaining four (4) were prepaid. This amounted to \$697,480 in loan balances and \$22,705 in prepayment penalties. In early analysis, these amounts were attributed to the first year's extraordinary expense. This caused two undesirable effects. The first being a large working capital loan and the second being a default ratio in excess of the 83% specified. To remedy this problem, the payment of the loans was added to the component section and capitalized. Loan prepayment was handled in the same manner.

The third mortgage used was a wrap-a-round. The amount and loan-to-value of this mortgage was determined through the backdoor approach using an 83% default ratio, an interest rate of 10.25%, and a 19 year term. The 19 year term was based on the longest running lease which expires in 1998 and the center's age at 36 years old.

After a review of the information provided in the BARI report and additional outside sources, scenerio three was chosen as the most likely situation to occure.

The map of the Fremont Trade Area and Bay Area Department Stores shows the possibility of the Fremont area being ready for major development, because of the lack of a large center with larger anchor tenants. the Fremont center is also 17 years old and a modern enclosed mall with a better layout and design would be more attractive to customers. Sears as a major tenant would seem to be a more attractive major tenant given its increasing popularity and increasing variety of services. The Fremont center's continued decline in market

share would suggest its falling appeal and a new center could use this to their advantage. Therefore, conditions seem to be good for development based on the assumptions mentioned.

The Fremont Syndication will be a limited partnership with a corporate general partner and individual limited partnership units at 300,000 will be available. Therefore, any investor can purchase up to two units. The general partner will be a corporation considered to have other income and meets the net worth requirements. The general partner has a 5% share in the cash flow, but a 25% share of the reversion to increase its staying power. The limited partnership shares divide the remainder of the cash flow and reversion. The investment value using scenerio III is \$14,750,000 and could be up to \$16,000,000.

REVENUE JUSTIFIED CAPITAL BUDGET DEFAULT RATIO APPROACH

	GROSS 2,060,000	
x		x .83
1 - .83		DEFAULT RATIO
=		=
RISK VARIABLES		1,709,800 OUTLAYS
350,200		-
-		505,826 EXPENSES
0		-
-		0 TAXES
0		-
=		0
CASH AVAILABLE		=
350,200		1,203,974
÷		DEBT SERVICE
.07		÷
DISTRIBUTION RATE		See Below CONSTANT
=		=
JUSTIFIED CASH		JUSTIFIED MORTGAGE
5,002,858		9,743,589
	+	
	TOTAL 14,746,447	
	-	
	0	
	IMPROVEMENT BUDGET	
	=	
	14,746,447	
	PROPERTY PURCHASE "AS IS"	

Mtg. Solution

1,203,974
 - 251,124 (Pacific Mutual)
 - 154,632 (Mason McDuffie)
 798,218
 ÷ .11971692
 6,667,545 (Wrap-around)

RUN NUMBER 0

PROFORMA
INVESTMENT ANALYSIS OF
FREMONT SYNDICATION
FOR
CHEMICAL BANK CLASS

REPORT SECTION NUMBER 1 PAGE 1

* GROSS RENT \$2328000. * RATE OF GROWTH OF GROSS RENT *****
* EXPENSES \$ 513642. * RATE OF GROWTH OF EXPENSES 0.0100
* R E TAXES \$ 0. * RATE OF GROWTH OF R E TAXES 0.0000
* INCOME TAX RATE 0.5000 PROJECT VALUE GROWTH TYPE 2.0000
* VACANCY RATE 0.0029 WORKING CAPITAL LOAN RATE 0.1400
EQUITY DISCOUNT 0.1200 EXTRAORDINARY EXPENSES \$ 0.
RESALE COST 0.0600 REINVESTMENT RATE 0.0800
WKG CAPITAL RS \$ 0. CAPITAL RESER INTEREST RATE 0.0600
INVESTOR TAX CLASS 0 OWNERSHIP FORM 1
INITIAL COST \$ 14746447. INITIAL EQUITY REQUIRED \$ 5002858.

ALL '*' VALUES ARE AVERAGE AMOUNTS FOR HOLDING PERIOD. OF 10 YRS.
INITIAL COST DERIVED THROUGH BACKDOOR TYPE 1 USING 3 MORTGAGES

RUN NUMBER 0

P R O F O R M A
INVESTMENT ANALYSIS OF
FREMONT SYNDICATION
FOR
CHEMICAL BANK CLASS

REPORT SECTION NUMBER 2
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PAGE 1

C O M P O N E N T S U M M A R Y

TITLE	PCT. DEPR	BEGIN USE	USEFUL LIFE	DEPR METHOD	COST	SCH
LAND	0.00	1	0.	0	\$ 3000000.	0
SHELL	0.95	1	20.	2	\$ 5274484.	0
MECHANICAL	0.95	1	10.	2	\$ 3692139.	0
PARKING PLUS	0.95	1	5.	2	\$ 1582345.	0
UNDERWRITING	0.99	1	5.	2	\$ 500000.	0
PAID OFF LOANS	0.00	1	0.	0	\$ 674775.	0
PREPAYMENT PENALTY	0.99	1	1.	2	\$ 22705.	0

M O R T G A G E S U M M A R Y

TITLE	INTR RATE	BEGIN YR.	END YR.	TERM	ORIG BALC	PCT VALUE
PACIFIC MUTUAL	0.0600	1	8	8	\$ 1641933.	0.111
MASON MCDUFFIE	0.0675	1	10	14	\$ 1434114.	0.097
WRAP AROUND	0.1025	1	10	19	\$ 6667542.	0.452

RUN NUMBER 0

PROFORMA
INVESTMENT ANALYSIS OF
FREMONT SYNDICATION
FOR
CHEMICAL BANK CLASS

REPORT SECTION NUMBER 3

PAGE 1

CASH FLOW ANALYSIS

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
1 GROSS RENT	2540000.	2520000.	2600000.	2660000.	2220000.	2150000.	2130000.	2310000.	2350000.	2400000.
2 LESS VACANCY	0.	0.	0.	0.	0.	0.	0.	44800.	22800.	0.
3 LESS REAL ESTATE TAXES	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
4 LESS EXPENSES	490950.	495860.	500818.	505826.	510885.	515993.	521153.	526365.	531629.	536945.
5 NET INCOME	2049050.	2024140.	2099182.	1554174.	1709115.	1634007.	1608847.	1738835.	1795571.	1863055.
6 LESS DEPRECIATION	1023415.	1000937.	1000937.	1000937.	1000937.	601291.	601291.	601291.	601291.	601291.
7 LESS INTEREST PMTS	867102.	840341.	811304.	779786.	745560.	708379.	667971.	624038.	578349.	541973.
8 TAXABLE INCOME	158534.	182862.	286941.	-226549.	-37382.	324337.	339585.	513506.	615931.	719791.
9 PLUS DEPRECIATION	1023415.	1000937.	1000937.	1000937.	1000937.	601291.	601291.	601291.	601291.	601291.
10 LESS PRINCIPAL PMTS	336872.	363633.	392669.	424188.	458414.	495595.	536003.	659817.	374501.	410877.
11 CASH THROW-OFF	845076.	820166.	895208.	350200.	505141.	430033.	404873.	454980.	842721.	910205.
12 LESS INCOME TAXES	79267.	91431.	143470.	0.	0.	162168.	169793.	256753.	307966.	359896.
13 LESS RESERVES	38290.	36437.	37587.	17510.	25257.	13393.	11754.	9911.	26738.	27515.
14 CASH FROM OPERATIONS	727519.	692298.	714151.	332690.	479884.	254471.	223326.	188315.	508018.	522794.
15 WORKING CAPITAL LOAN	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
16 DISTRIBUTABLE CASH AFTER TAX	727519.	692298.	714151.	332690.	479884.	254471.	223326.	188315.	508018.	522794.
17 TAX SAVINGS ON OTHER INCOME	0.	0.	0.	113274.	18691.	0.	0.	0.	0.	0.
18 SPENDABLE CASH AFTER TAXES	727519.	692298.	714151.	445965.	498575.	254471.	223326.	188315.	508018.	522794.

MARKET VALUE & REVERSION

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CASH FLOW ANALYSIS

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	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
19 END OF YEAR MARKET VALUE	18441450.	18217260.	18892638.	13987566.	15382035.	14706063.	14479623.	15649515.	16160139.	16767495.
20 LESS RESALE COST	1106487.	1093036.	1133558.	839254.	922922.	882364.	868777.	938971.	969608.	1006050.
21 LESS LOAN BALANCES	9406717.	9043084.	8650414.	8226227.	7767813.	7272217.	6736215.	6076397.	5701896.	5291019.
22 PLUS CUM. CASH RESERVES	38290.	77025.	119233.	143897.	177788.	201848.	225713.	249167.	290855.	335822.
23 BEFORE TAX NET WORTH	7966537.	8158165.	9227899.	5065983.	6869088.	6753331.	7100345.	8883315.	9779491.	10806249.
24 CAPITAL GAIN (IF SOLD)	3611932.	4402128.	6037921.	2428090.	4739827.	4705704.	5094142.	6795132.	7876410.	9048615.
25 CAPITAL GAINS TAX	722386.	880426.	1207584.	485618.	947965.	941141.	1018828.	1359026.	1575282.	1809723.
26 MINIMUM PREF. TAX	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
27 INCOME TAX ON EXCESS DEP.	0.	0.	0.	0.	0.	0.	0.	0.	0.	0.
28 TOTAL TAX ON SALE	722386.	880426.	1207584.	485618.	947965.	941141.	1018828.	1359026.	1575282.	1809723.
29 AFTER TAX NET WORTH	7244150.	7277740.	8020315.	4580365.	5921123.	5812190.	6081516.	7524289.	8204209.	8996526.

BEFORE TAX RATIO ANALYSIS

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CASH FLOW ANALYSIS

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	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
30 RETURN ON NET WORTH B/4 TAX	0.7613	0.1270	0.2409	-0.4131	0.4556	0.0458	0.1113	0.3152	0.1957	0.1981
31 CHANGE IN NET WORTH B/4 TAX	2963679.	191629.	1069734.	-4161917.	1803106.	-115758.	347014.	1782971.	896176.	1026758.
32 ORIG EQUITY CASH RTNB/4 TAX	0.1689	0.1639	0.1789	0.0700	0.1010	0.0860	0.0809	0.0909	0.1684	0.1819
33 ORIG EQUITY PAYBACK B/4 TAX	0.1454	0.2838	0.4265	0.4930	0.5890	0.6398	0.6845	0.7221	0.8237	0.9282
34 B/4 TAX PRESENT VALUE	17611100.	17655592.	18357382.	15231226.	16196039.	15937649.	15911181.	16470926.	15071647.	15317450.

AFTER TAX RATIO ANALYSIS

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CASH FLOW ANALYSIS

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	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
35 RETURN ON NET WORTH AFR TAX	0.5934	0.1002	0.2002	-0.3733	0.4016	0.0246	0.0848	0.2682	0.1579	0.1603
36 CHANGE IN NET WORTH AFR TAX	2241292.	33590.	742576.	-3439951.	1340758.	-108933.	269327.	1442773.	679921.	792317.
37 ORIG EQUITY CASH RTNAFR TAX	0.1454	0.1384	0.1427	0.0891	0.0997	0.0509	0.0446	0.0376	0.1015	0.1045
38 ORIG EQUITY PAYBACK AFR TAX	0.1454	0.2838	0.4265	0.5157	0.6153	0.6662	0.7109	0.7485	0.8500	0.9545
39 AFTER TAX PRESENT VALUE	16861150.	16746825.	17162076.	14647696.	15379501.	15093256.	15000611.	15364633.	13825482.	13931928.

CASH FLOW ANALYSIS

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	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
40 NET INCOME-MARKET VALUE RTO	0.1111	0.1111	0.1111	0.1111	0.1111	0.1111	0.1111	0.1111	0.1111	0.1111
41 LENDER BONUS INTEREST RATE	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
42 DEFAULT RATIO	0.6673	0.6745	0.6557	0.8300	0.7725	0.8000	0.8099	0.7836	0.6317	0.6207

MODIFIED INTERNAL RATE OF RETURN ANALYSIS

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RETURN ANALYSIS WITHOUT SALE

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CASH FLOW ANALYSIS

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	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
43 CUM. AFR TAX SPENDABLE CASH	727519.	1478018.	2310411.	2941209.	3675080.	4223558.	4784770.	5355867.	6292354.	7318537.
44 MOD. I.R.R. ON ORIG EQUITY	-0.8546	-0.4565	-0.2270	-0.1244	-0.0598	-0.0278	-0.0063	0.0086	0.0258	0.0388
45 MOD. I.R.R. ON CUM. EQUITY	-0.8546	-0.4565	-0.2270	-0.1244	-0.0598	-0.0278	-0.0063	0.0086	0.0258	0.0388

RETURN ANALYSIS WITH SALE

=====

CASH FLOW ANALYSIS

=====

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
46 CUM. CASH LESS ORIG EQUITY	2968811.	3752900.	5327868.	2518715.	4593345.	5032890.	5863428.	7877297.	9493705.	11312205.
47 CUM. CASH LESS CUM. EQUITY	2968811.	3752900.	5327868.	2518715.	4593345.	5032890.	5863428.	7877297.	9493705.	11312205.
48 MOD. I.R.R. ON ORIG EQUITY	0.5934	0.3229	0.2734	0.1073	0.1391	0.1230	0.1172	0.1255	0.1255	0.1255
49 MOD. I.R.R. ON CUM. EQUITY	0.5934	0.3229	0.2734	0.1073	0.1391	0.1230	0.1172	0.1255	0.1255	0.1255

MORTGAGE AMORTIZATION SCHEDULE FOR PACIFIC MUTUAL

MORTGAGE AMOUNT	1641933.	TERM	8
INTEREST RATE	0.0600	MORTGAGE FACTOR	0.01274534
PERIOD PAYMENT	20927.00	PAYMENTS PER YEAR	12
BONUS INTEREST	0.0000	TYPE 0 GREATER THAN	0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	251124.	94249.	156875.	1485058.	0.
2	251124.	84573.	166551.	1318506.	0.
3	251124.	74300.	176824.	1141683.	0.
4	251124.	63394.	187730.	953953.	0.
5	251124.	51815.	199309.	754644.	0.
6	251124.	39522.	211602.	543042.	0.
7	251124.	26471.	224653.	318390.	0.
8	251124.	12615.	318390.	0.	0.

MORTGAGE AMORTIZATION SCHEDULE FOR WRAP AROUND

MORTGAGE AMOUNT	6667542.	TERM	19
INTEREST RATE	0.1025	MORTGAGE FACTOR	0.00997641
PERIOD PAYMENT	66518.13	PAYMENTS PER YEAR	12
BONUS INTEREST	0.0000	TYPE 0 GREATER THAN	0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	798218.	677874.	120344.	6547198.	0.
2	798218.	664942.	133276.	6413923.	0.
3	798218.	650621.	147597.	6266326.	0.
4	798218.	634761.	163457.	6102869.	0.
5	798218.	617196.	181021.	5921848.	0.
6	798218.	597745.	200473.	5721375.	0.
7	798218.	576203.	222015.	5499360.	0.
8	798218.	552346.	245871.	5253489.	0.
9	798218.	525926.	272291.	4981197.	0.
10	798218.	496667.	301551.	4679647.	0.

MORTGAGE AMORTIZATION SCHEDULE FOR MASON MCDUFFIE

MORTGAGE AMOUNT	1434114.	TERM	14
INTEREST RATE	0.0675	MORTGAGE FACTOR	0.00898536
PERIOD PAYMENT	12886.03	PAYMENTS PER YEAR	12
BONUS INTEREST	0.0000	TYPE 0 GREATER THAN	0.

YR	ANNUAL PAYMENT	INTEREST PAYMENT	PRINCIPAL PAYMENT	BALANCE	BONUS INT PAYMENT
1	154632.	94980.	59653.	1374461.	0.
2	154632.	90826.	63806.	1310655.	0.
3	154632.	86383.	68249.	1242406.	0.
4	154632.	81631.	73001.	1169405.	0.
5	154632.	76548.	78084.	1091321.	0.
6	154632.	71112.	83521.	1007801.	0.
7	154632.	65296.	89336.	918465.	0.
8	154632.	59076.	95556.	822908.	0.
9	154632.	52423.	102210.	720698.	0.
10	154632.	45306.	109326.	611372.	0.

REPORT SECTION

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SENSITIVITY ANALYSIS

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ANALYSIS YEAR IS 4 = 1982

DEFAULT RATE - NEEDED -	0.8500	0.8500	0.8500	0.8500
DEFAULT RATE - ACTUAL -	0.6557	0.8300	0.7725	0.8000
DIFFER -	0.1943	0.0200	0.0775	0.0500

TO CHANGE THE DEFAULT RATE .01
CHANGE ANY ONE OF THE FOLLOWING

CASH OUTLAYS		1981	1982	1983	1984
=====					

REAL ESTATE TAXES	BY	0.0000	0.0000	0.0000	0.0000
TOTAL EXPENSES	BY	0.0519	0.0407	0.0435	0.0417
FIXED EXPENSES	BY	0.0519	0.0407	0.0435	0.0417
VARIABLE EXPENSES	BY	0.0000	0.0000	0.0000	0.0000
TOTAL INTEREST PMTS.	BY	0.0320	0.0264	0.0298	0.0304
TOTAL PRINCIPAL PMTS.	BY	0.0662	0.0486	0.0484	0.0434
WORKING CAPITAL LOAN	BY	0.0000	0.0000	0.0000	0.0000
GROSS INCOME	BY	-0.0066	-0.0083	-0.0077	-0.0080
FIXED INCOME	BY	-0.0066	-0.0083	-0.0077	-0.0080
VARIABLE INCOME	BY	0.0000	0.0000	0.0000	0.0000

REPORT SECTION

SENSITIVITY ANALYSIS

ANALYSIS YEAR IS 4 = 1982

TO CHANGE CASH RETURN BEFORE TAXES BY 10000.
CHANGE ANY ONE OF THE FOLLOWING

CASH OUTLAYS		1981	1982	1983	1984
REAL ESTATE TAXES	BY	0.0000	0.0000	0.0000	0.0000
TOTAL EXPENSES	BY	0.0200	0.0198	0.0196	0.0194
FIXED EXPENSES	BY	0.0200	0.0198	0.0196	0.0194
VARIABLE EXPENSES	BY	0.0000	0.0000	0.0000	0.0000
TOTAL INTEREST PMTS.	BY	0.0123	0.0128	0.0134	0.0141
TOTAL PRINCIPAL PMTS.	BY	0.0255	0.0236	0.0218	0.0202
WORKING CAPITAL LOAN	BY	0.0000	0.0000	0.0000	0.0000
GROSS INCOME	BY	0.0038	0.0049	0.0045	0.0047
FIXED INCOME	BY	0.0038	0.0049	0.0045	0.0047
VARIABLE INCOME	BY	0.0000	0.0000	0.0000	0.0000

REPORT SECTION

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FRONT DOOR ANALYSIS

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ASSUMPTIONS

=====

ANALYSIS YEAR IS 4 = 1982

CASH FLOW

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GROSS INCOME	1.000	EXPENSES	0.246
FIXED INCOME	1.000	FIXED EXPENSES	0.246
VARIABLE INCOME	0.000	VARIABLE EXPENSES	0.000
VACANCY	0.000	REAL ESTATE TAXES	0.000
DEBT REPAYMENT	0.584	EQUITY PAYMENT	0.170

DEBT STRUCTURE

=====

TOTAL DEBT IN EFFECT	0.584
PACIFIC MUTUAL	0.122
MASON MCDUFFIE	0.075
WRAP AROUND	0.387

EQUITY CONTRIBUTION

=====

TOTAL EQUITY	0.170
COST LESS DEBT	0.170 AT ANNUAL RATE OF 0.070
WKG CAPITAL RS	0.000 AT ANNUAL RATE OF 0.070

FRONT DOOR ANALYSIS

=====

CASH FLOW

=====

PERCENTAGE BASIS

=====

ANALYSIS YEAR IS 4 = 1982

	TEST	TEST	TEST
	AT 1.00	AT 1.05	AT 0.95
TYPE 0 VALUE ESTIMATE =	14746447.	15483769.	14009124.

EQUITY RETURN BASIS
REQUIRED CASH FLOW

	YR.	#	YR.	#	YR.	#
GROSS RENT	2060000.	4.65	2163000.	4.89	1957000.	4.42
LESS VACANCY	0.	0.00	0.	0.00	0.	0.00
LESS R.E. TAXES	0.	0.00	0.	0.00	0.	0.00
LESS EXPENSES	505826.	1.14	531117.	1.20	480535.	1.09
NET INCOME	1554174.	3.51	1631883.	3.69	1476465.	3.34
DEBT SERVICE	1203974.	2.72	1264173.	2.86	1143775.	2.58
CASH THROW-OFF	350200.	0.79	367710.	0.83	332690.	0.75

DEFAULT = 0.83000

ZERO EQUITY RETURN BASIS
REQUIRED CASH FLOW

	YR.	#	YR.	#	YR.	#
GROSS RENT	1595823.	3.61	1675614.	3.79	1516032.	3.43
LESS VACANCY	0.	0.00	0.	0.00	0.	0.00
LESS R.E. TAXES	0.	0.00	0.	0.00	0.	0.00
LESS EXPENSES	391849.	0.89	411441.	0.93	372256.	0.84
NET INCOME	1203974.	2.72	1264173.	2.86	1143775.	2.58
DEBT SERVICE	1203974.	2.72	1264173.	2.86	1143775.	2.58
CASH THROW-OFF	0.	0.00	0.	0.00	0.	0.00

DEFAULT = 1.00000

RISK ADJUSTED BASIS WITH DEFAULT AT 0.850 AND ALLOCATING-26093.38 DOLLARS
REQUIRED CASH FLOW

	YR.	#	YR.	#	YR.	#
GROSS RENT	2043843.	4.62	2146035.	4.85	1941651.	4.39
LESS VACANCY	0.	0.00	0.	0.00	0.	0.00
LESS R.E. TAXES	0.	0.00	0.	0.00	0.	0.00
LESS EXPENSES	533293.	1.21	559957.	1.27	506628.	1.14
NET INCOME	1510550.	3.41	1586078.	3.58	1435023.	3.24
DEBT SERVICE	1203974.	2.72	1264173.	2.86	1143775.	2.58
CASH THROW-OFF	306576.	0.69	321905.	0.73	291248.	0.66

DEFAULT = 0.85000

FRONT DOOR ANALYSIS

=====

CASH FLOW

=====

CASH BASIS

=====

ANALYSIS YEAR IS 4 = 1982

	TEST	TEST	TEST
	AT 1.00	AT 1.05	AT 0.00
TYPE 0 VALUE ESTIMATE =	14746447.	15483769.	14009124.

EQUITY RETURN BASIS
REQUIRED CASH FLOW

	YR.	#	YR.	#	YR.	#
GRUSS RENT	2060000.	4.65	2137709.	4.83	1982291.	4.48
LESS VACANCY	0.	0.00	0.	0.00	0.	0.00
LESS R.E. TAXES	0.	0.00	0.	0.00	0.	0.00
LESS EXPENSES	505826.	1.14	505826.	1.14	505826.	1.14
NET INCOME	1554174.	3.51	1631883.	3.69	1476465.	3.34
DEBT SERVICE	1203974.	2.72	1264173.	2.86	1143775.	2.58
CASH THROW-OFF	350200.	0.79	367710.	0.83	332690.	0.75

DEFAULT = 0.83000

ZERO EQUITY RETURN BASIS
REQUIRED CASH FLOW

	YR.	#	YR.	#	YR.	#
GROSS RENT	1709800.	3.86	1769999.	4.00	1649601.	3.73
LESS VACANCY	0.	0.00	0.	0.00	0.	0.00
LESS R.E. TAXES	0.	0.00	0.	0.00	0.	0.00
LESS EXPENSES	505826.	1.14	505826.	1.14	505826.	1.14
NET INCOME	1203974.	2.72	1264173.	2.86	1143775.	2.58
DEBT SERVICE	1203974.	2.72	1264173.	2.86	1143775.	2.58
CASH THROW-OFF	0.	0.00	0.	0.00	0.	0.00

DEFAULT = 1.00000

RISK ADJUSTED BASIS WITH DEFAULT AT 0.850 AND ALLOCATING-23564.27 DOLLARS
REQUIRED CASH FLOW

	YR.	#	YR.	#	YR.	#
GROSS RENT	2043843.	4.62	2119256.	4.79	1968430.	4.45
LESS VACANCY	0.	0.00	0.	0.00	0.	0.00
LESS R.E. TAXES	0.	0.00	0.	0.00	0.	0.00
LESS EXPENSES	533293.	1.21	537195.	1.21	529390.	1.20
NET INCOME	1510550.	3.41	1582061.	3.57	1439040.	3.25
DEBT SERVICE	1203974.	2.72	1264173.	2.86	1143775.	2.58
CASH THROW-OFF	306576.	0.69	317888.	0.72	295264.	0.67

DEFAULT = 0.85000

BACK DOOR ANALYSIS
=====

COMPONENTS
=====

PERCENTAGE BASIS
=====

ANALYSIS YEAR IS 4 = 1982

	TEST	TEST	TEST
	AT 1.00	AT 1.05	AT 0.95
GROSS RENT PROJECTED	2060000.	2163000.	1957000.
REVENUE UNIT INCOME	4.655	4.887	4.422

JUSTIFIED COMPONENTS

TYPE 0 VALUE ESTIMATE = 14746449. 15483772. 14009127.

VALUE DIFFERENCE = 2. 737325. -737320.

LAND	3000001. 0.000	3150001. 0.050	2850001.-0.050
SHELL	5274485. 0.000	5538209. 0.050	5010760.-0.050
MECHANICAL	3692139. 0.000	3876746. 0.050	3507532.-0.050
PARKING PLUS	1582345. 0.000	1661463. 0.050	1503228.-0.050
UNDERWRITING	500000. 0.000	525000. 0.050	475000.-0.050
PAID OFF LOANS	674775. 0.000	708514. 0.050	641036.-0.050
PREPAYMENT PENAL	22705. 0.000	23840. 0.050	21570.-0.050
PACIFIC MUTUAL	1641933. 0.000	1724030. 0.050	1559837.-0.050
MASON MCDUFFIE	1434114. 0.000	1505820. 0.050	1362409.-0.050
WRAP AROUND	6667543. 0.000	7000921. 0.050	6334166.-0.050
EQTY CONTRIBUTION	5002858. 0.000	5253001. 0.050	4752716.-0.050

REAL ESTATE EQUITY INVESTMENT

Class Problem #1

Mr. Orvil P. Anderson (yes folks, he's back) has received an investment proposal which he would like you to review. The proposal is as follows:

Projection Period = 5 years
Net Operating Income = 73,600, Year 1
76,128, Year 2
78,736, Year 3
81,427, Year 4
84,203, Year 5
Purchase Price = 675,000
Mortgage Ratio = 80%
Interest Rate = 11.5%
Term = 25 years
Payments Per Year = 12
Improvement To Price Ratio = 80%
Improvement Life = 39
Depreciation Method = 125%
Income Tax Rate = 50%
Resale Price = 750,000

Question:

If Orvil has an opportunity cost of equity capital of 20% and a 4 year after tax reinvestment rate of 6%,

- A. What is the Net Present Value (NPV) of the project?
- B. What is the M.I.R.R.?
- C. What % of "B" is created by the resale assumption?
- D. What is the NPV if the equity is paid in three equal installments 6 months apart?

You may use any tool available to you to solve this problem, except your friends, neighbors, business associates, etc.

Have the following ready to turn in at the next class period (1/30/80):

- A. Solution to 4 questions
- B. Identification of tools utilized

BUSINESS 850

REAL ESTATE EQUITY INVESTMENT

Solution to Problem Set #1 - *Not applicable to previous problem*

A. Future Value

6,500 Today

Annual Rate = 5-7/8%

Compounded Daily

Holding Period = 6 yrs., 4 mos., 2 wks. and 5 days

$$N = (((((6 * 12) + 4) * 4) + 2) * 7) + 5) = 2147 \text{ days}$$

$$i = 7 \div 8 = .875 + 5 = 5.875 \div 100 = .05875$$

$$.05875 \div 365 = .0001609589$$

$$\text{Factor} = 1.0 + .0001609589 = 1.000160959$$

$$= (1.000160959)^{2147} = 1.412768081$$

$$\text{F.V.} = 1.412768081 * 6500 = \underline{9182.99}$$

Formula:

$$\text{F.V.} = \text{P.V.} * (1. + i)^n$$

$$\text{P.V.} = \text{F.V.} * (1. + i)^{-n}$$

B. What is New "N"

$$N = \frac{\log \frac{10,000}{6,500}}{\log (1.000160959)} = \frac{\log 1.538461538}{\log 1.000160959}$$

$$N = \frac{.4307829161}{.000160946}$$

$$N = 2676.567 \text{ or } \sim \underline{2677}$$

$$2677 - 2147 = 531 \text{ days more}$$

$$= 75.79 \text{ wks.}$$

$$= 17.11 \text{ mos.}$$

$$= 1.45 \text{ yrs.}$$

Formula:

$$N = \frac{\ln \left[\frac{\text{F.V.}}{\text{P.V.}} \right]}{\ln (1. + i)}$$

Solution to Problem Set #1

Formula (cont.):

Chk.

$$F.V. = 6500 * ((1.0 + .000160959)^{2676.567})$$

$$F.V. = 6500 * 1.538461482$$

$$F.V. = 9999.999634$$

C. What is new (i)

$$i = \left[\frac{10,000}{6,500} \right]^{.0004657662} - 1.0$$

$$i = ((1.538461538)^{.0004657662}) - 1.0$$

$$i = 1.000200664 - 1.0$$

$$i = .000200664$$

$$\text{Annual } i = .000200664 * 365 = \underline{.0732424516}$$

Formula:

$$i = \left[\frac{F.V.}{P.V.} \right]^{1/N} - 1.0$$

Chk.

$$F.V. = 6500 * (1.0 + .000200664)^{2147}$$

$$F.V. = 6500 * 1.538460727$$

$$F.V. = 9999.994724$$

D. Mortgage Term (N)

$$N = (((6 * 12) + 4) * 4) + 2 = 306$$

$$N = \underline{306}$$

Solution to Problem Set #1

E. Mortgage Amortization Factor

a. By sinking fund method

$$1. \text{ Annual } i = 7 \div 32 = .21875 \div 5 = 5.21875 \div 100 = .05$$

$$i = \underline{.0521875}$$

$$2. \text{ Weekly } i = .0521875 \div 52 = \underline{.0010036058}$$

$$3. \text{ Compounding Factor (F.V.)} = (1.0 + i)^n$$

$$\text{F.V.}^{\text{Fac}} = (1.0 + .0010036058)^{306}$$

$$\text{F.V. Fac} = 1.359272137$$

$$4. \text{ Sinking Fund Factor (S.F.)} = \frac{i}{\text{F.V. Fac} - 1}$$

$$\text{S.F.} = \frac{.0010036058}{1.359272137 - 1.0}$$

$$\text{S.F.} = \underline{.0027934418}$$

$$5. \text{ Amortization Factor (A.F.)} = \text{S.F.} + i$$

$$\text{A.F.} = .0027934418 + .0010036058$$

$$\text{A.F.} = \underline{.0037970476}$$

b. By present value method

$$1. \text{ P.V. of } 1 = (1.0 + i)^{-N}$$

$$2. \text{ P.V. Fac} = (1.0 + .0010036058)^{-306}$$

$$\text{P.V. Fac} = .7356880259$$

$$3. \text{ Amortization Factor (A.F.)} = \frac{i}{1 - \text{P.V. Fac}}$$

$$\text{A.F.} = \frac{.0010036058}{1.0 - .7356880259} \quad (\#2 \text{ above})$$

$$\text{A.F.} = \frac{.0010036058}{.2643119741}$$

$$\text{A.F.} = \underline{.0037970501}$$

Solution to Problem Set #1

F. Mortgage Payment Amount (Pmt)

$$\text{Pmt} = 3500 * .0037970476$$

$$\text{Pmt} = 13.2896666 \text{ per wk.}$$

$$\text{Pmt} = \sim 13.29 \text{ per wk.}$$

G. Mortgage Constant (M.C.) = A.F. * Pmt per yr.

$$\text{M.C.} = .0037970476 * 52$$

$$\text{M.C.} = .1974464752$$

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 characterizes 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 worlds developing countries began to specialize in capital intensive production

- result of above: American industries are becoming uncompetetaive 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 seperate 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 RESRTRUCTURING OF BUSINESS, LABOR & GOVERTMENT

- relationships between the above three entities must become less ridgidly 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 estate tax by making inter vivos transfers and to avoid double taxation. It is allowed for gifts made from the estate--not made in the life of the donor. If interested the computation for the gift 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 from 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 states that any sale is a taxable transaction and one must recognize the gain or loss. The author goes through three areas--depreciation 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 depreciation 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.

III. Minimum Taxation on sale:

For corporate investor this is taxed as a regular preference

Corporate: Net LT cap Gains $\frac{(.46-.28)}{.46}$ = LT subject to minimum tax

The corporation can exclude this or \$10,000 (the lesser)

The non corporate investor uses it as an alternative tax preference and would apply it only when greater than the regular income and tax preferences. Example:

\$50,000 income and \$50,000 long term capital gain

\$50000

plus \$20000 which is $(.4 * \text{LT cap gain})$

\$70000

Using tax table this would be \$22,605 tax liability. Otherwise one could:

\$70000

plus 30000 the exclusion (50000-20000)

100000

Using the tax table this would be a \$12,000 tax liability and the indiv. is required to pay the higher of the two. That is, \$22,605.

Finally the author discusses depreciation methods and recommends that for non-residential maximum benefit will result with straightline, while for residential the hot tip is accelerated depreciation.

Chapter 11 "After Tax Cash Flow From Sale"

Kau and Sirmans (1982)

Tax Planning for Real Estate Investors

This was in the reading packet and not assigned. It follows directly from the previous chapter and gives examples of the principles brought out in Chapter 10. That is, forecasting the after tax cash flow incorporating depreciation recapture, capital gains, and minimum tax. There are three examples--an individual, a partnership, and a syndication. If you are confused about the tax impacts on a sale of real estate you may want to glance at the cash flows as they are all in table form within the article.

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 (15)

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 interest, 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 (OID) 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 nad than 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. --

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)

2/4 CC (850)

Elaine Worzala

lots of experience
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.

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 Tomorrow'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 a lot of properties. The author sees this occurring.

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 a lot of the type and form of development, financial institutions will own a lot 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 investors.

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

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

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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.

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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 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.

10. Capital Outlay Requirements: Some forms of ownership are significantly more costly to organize than others.

11. Diversification: Can be achieved by one entity (REIT or Corp.) or may be prohibited by ownership agreement -- such as joint venture limited to one property.

12. Regular Return: Some forms more conducive to regular distribution of return than others. REIT. Corp. form might choose to accumulate earnings and reinvest.

13. Estate Building: If not concerned with regular income, an investor might prefer corporate form or family trust.

14. Retirement Fund: Build equity during younger years so that property is owned free and clear at retirement. Individual ownership might be best, or Keough if self employed.

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.

C. Tenancy in Common: Two or more people, each has undivided interest, no right of survivorship. But interests in property can be unequal. Interest is freely transferrable. Buyer becomes a new tenant in common.

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.

D. General Partnership: Similar to a TC except for two major characteristics: 1) A partnership should have a partnership agreement. TC often presumed to exist in absence of such agreement. 2) Partnership must file a fed. tax return. TC doesn't. Paragraph about this on page 220 (TC not filing tax return) that is worth reading.

Advantages: Flexibility is primary advantage: structuring agreement, delegating responsibility, voting rights, preferential returns etc. But must define clearly.

Tax advantages: direct conduit, can pass through losses, gains.

Disadvantages: 3 main disadvantages: 1) unlimited liability 2) limited transferability of interest 3) lack of continuity. In practice these may or may not be disadvantages. Can be avoided by careful structuring.

But the risk is that a tax reclassification may take place. Usually more a problem with ltd. partnerships but also can be with Gen.

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 it's 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 ~~a~~ 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.

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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. Industrialbuilding and parks: National and international facilities will continue to benefit SouthWest expecially 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 ^{behavior} 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 estat 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 ~~is~~ the comingled fund encourages ~~high~~ 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 ^{investing} ~~finally~~ 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 investmnt 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 operating.
- 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 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 downpmnts 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, building 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

In your mimeograph packet there will be (ultimately) proposals about the 87 law; tax Matters in Real Estate have become a moving target. Lecture notes from one semester to another are relatively classic. First of all, relative to the text book, we do have Cooper and Pyhrr at the bookstore. If you are relatively new to the program I advise you to get the book as it will help you to pull things together. For those of you who have been with us for a while, you'll probably find it redundant. Four or five of the chapters are on the 1982 tax law which, unless you're into history, the thing is useless. Initially they were going to have their new addition out but knowing Cooper and Pyhrr, they aren't going to have it done until next Sept., at the earliest. So I have completely rebuilt the syllabus and plagiarized a great many additional readings which we'll adjust to the changing industry here, and the change in the tax laws, and the change in the institutional investment, and for that matter changes in structuring and so forth which is going on presently and try to make it as current as possible with readings up through Oct. and Dec. of 87; and including some excerpts from several new books that are out. Three chapters from the new book Riches into Ruin in Real Estate with Jim Powell who is a New York Times finance reporter that has so far one of the big players in real estate, a make a deal maker, and I think it's a pretty

interesting book. It's organized in such a way that it will give you some different ideas about areas of expertise such as construction management and looking at the skills involved in that. Looking at liability, there's a whole chapter on the Kansas City disaster at the Hyatt and implications of that and so forth, which has had some pretty peculiar implications on structuring pension funds and global liability move through and so forth and so on. Some of the players some of the disasters, the near disaster of Trammell Crow, and the resulting restructuring of Trammell, Crow to take control away from Trammell and put it in the partners that are coming along and might cause internal friction. And also I think you'll find some new names as well as some familiar ones involved as to who the big players are and what kind of folks they are. And so anyway, it's an interesting book if you have some time for a little extra reading. We also have Natalie McKelties book on Pension Fund Investment, we've taken several chapters out of that relative to pension funds strategies, mistakes, opportunities and so forth. I think you'll find a fairly wide selection of alternative sources of material which is one of the purposes of the reading list to sensitize you to the great variety of literature that's available one way or another and then organize that by subject matter. We'll probably expand on that as appropriate.

The second thing we need to have is Mark Eply as a TA in the course, specifically for bending your case studies onto the computer. He'll be a computer resource as well as a computer instructor for you. Mark's spent a lot of time and he's been poking around with Mike Robbins, trying to find a somewhat different format for computer use and here one of your problems is going to be choosing probably the appropriate software package that allows you to get the job done and address the real issues both particularly, and at the same time, we want to you take a look at a program called "PRO-JECT". Some of you are already familiar with it and the PRO-JECT people are very nice and allowed us a series of copies which will be locked into the hard disc machines upstairs; ten of them set up for you upstairs with manuals and so forth. It's a lease-by-lease program, as well as a fairly sophisticated current tax program. It also has a program called Dynamis, which then allows you to move through the base cash flow and start constructing matrixes of whatever ratios it is you think are relevant, rather than just simply getting what the program provides or doesn't provide. It also gives you an opportunity to structure and decide whether a partnership or a corporate shell or whatever, you know, might be more desirable, at least from a financial stand-point, not necessarily on other factors. And it is probably a program that's taking over out there in

the industry. "Finsim II" has had its day, Mr. Grant has died, it has not been updated adequately - the age of the changing tax laws certainly changing pace with changing attitudes as real estate investors change what's important in terms of financial analysis, and " PRO-JECT" is. I think once you get out there you'll find a significant percentage of the institutional investors are using " PRO-JECT" in-house if they don't have their own system, and their own system is probably quite similar. Mr. Sterns has been very nice in cooperating with us and providing the program. It is a program which sells for about \$6,000 and we have, therefore, taken precautions to protect it and the manuals, so please respect that. They have given us about \$60,000 worth of software. We'll protect our tail feathers by not abusing that. There will be talks based on its use a little later.

We also have another program called DNA which has a much more elaborate state tax model, looking at what different states would tax real estate for, which is now often considered in the investment courses with regard the federal law as the end all and be all. And in this course while we will down play a little bit the income tax game as its not as much of a game to play anymore, the real game is the estate tax law, the inheritance tax process, and therefore we will spend more time on that aspect of real

estate and in structuring to minimize the friction, through the process and minimize the tax burden on the process, and looking at real estate as a wealth transfer device from generation-to-generation as well as a wealth generation developer for the initial older investor. And the course will be split approximately six weeks on the individual investor side, about six weeks on the institutional investor's side and then about six weeks looking at the new media in terms of what REITs are doing and commingled funds and NLBs and REMICS and whatever. What are the pros and cons.

As many of you know, my favorite questions on the final are typically matrixes which say okay guys, here's five different structural frameworks for the real estate and here's twelve attributes relative to liquidity, and control, and risk, and so on, and you know, now compare and contrast on my little grid and matrix and so forth. So I'm going to give you a way to kind of organize you thoughts and boiling them down to the critical element. Okay. The two guides that we have are on the syllabus, one is courtesy of the Equitable and the other is not the courtesy of the Equitable, we had to pay for those. The reading packet is relatively enormous. It should be available by late Friday or early Saturday at Bob's at the corner of Randall and Johnson. I threw out about four and half inches. And I

added about ten. So even if 40% remain from last year there's only 20% of the new pile. In the process I had very interesting conversations with technical authors, Gary Cooper and Mike Farrow and Dale Ingrea, who have a new book out on real estate investment and so forth. And the problem is what they call real estate investment we teach in 550 and 551. And have gone well beyond their textbooks for that. For us there's just nothing out there. We got talking about Kenneth Leventhal and Stan Ross out there and Stan Ross says gee, we're kinda thinking about doing something jointly with Kenneth Leventhol and coming out with a real estate investment text or at least an anthology or something that would cover the need, because there's just nothing out there. There really isn't so I apologize for three pounds of mimeograph and so forth but them's the conditions what prevail, in what is a very rapidly moving area. In fact if any of you are thinking about coming professors I recommend that you consider serious ancient history where material does not change substantially from the time you're a graduate student until you're on social security. As long as your notes remain legible you're in business, but I have about four pamphlet files of notes for this course which are no longer relevant and I think I will hold ancient history in my next life cycle and if anybody finds an old scroll I

will deny it as a fraud and continue forward. Now, let's talk a little bit about real estate investment.

There is a tremendous deep dividing irony about teaching real estate investment in terms of the detail and complexity and presumption of rational systems that we have here because ultimately investment in real estate is simply a statement of hope. Think about that. It's really ironical that we spend that much time rationalizing something which essentially and ultimately is an irrational move. It is based on hope. You have absolutely no empirical reason for doing what you're doing, other than whatever system comes to mind at the moment. Think about that--its really ironic, we're making comments about a 15 or 20 or 30 year investment, which presumes essentially, that the social, and cultural, and technical elements will move forward at an orderly pace and to the degree that there's change there will be plenty of time for you to improvise and adjust accordingly, and of course, you have the eternal piece of garbage that says change always provides opportunity for creative advantage. Phewy. Find a creative advantage in a ranch for a real estate investor. You really need to look for the implicit assumptions which are statements of hope, and hope is what you're building the whole damn thing on. And therefore, you really begin as a real estate investor the statement of faith about people,

and politics, and about systems, and technology, and that's the context in which you're operating, and that's pretty mushy. To do financial ratios two decimal places when the whole damn thing rests on, you know, on whether somebody is going to shoot at somebody in the Persian Gulf - its insanity, fundamentally and blatantly. What you're really doing is you're making a commitment on faith, and then, rationalizing it so you feel good. It's a strange statement to make in a finance course in which we're going to worry about punching numbers and decimals, 1% rate of return and so forth and so on - it just isn't there. Deep down underneath you are building on shifting sands in which you're made a statement about faith. Real estate ultimately is a religious experience that I support. Real estate investment is all futuristic and it's all extrapolating on what we think we know. We move from irrational hope towards some sort rationalized attitude, and then ultimately we come up with an intellectual strategy that says hey, all things considered, this isn't bad, this is--if Reagan uses the Neutron bomb, well at least the real estate will survive. So in any event we have this basic dichotomy that at some point, real estate investment is a leaping assumption about the future and our ability to adjust and survive in a changing world.

One element of the course that helps that in the past was that how long is the time line of hope? We can have hopes that are three years long or hopes that are 25 years long and what's the time line of the hope? In some ways that's a very forgiving kind of thing. Pension funds tend to be more patient with their capital than you, who will starve if you don't flip the property within a few moments of the time of closing, but nevertheless we need to know what is the time line of hope. What's the time line of the pension fund versus the home buyer? How much does he have to rationalize, and what's his downside in terms of his hopes? And one thing we need to be aware of is that in our approach, to trying to get a handle on our hope, and structure that into some sort of rationalized attitude, how often are we being infected by topical attitudes, short term kinds of things? Investing against the tide is one premise, that everybody's wrong therefore, if they're buying, I'm selling, if they're selling, I'm buying, sort of thing that's certainly a statement about a topical attitude, certainly the contrarian position and his saying that essentially if you bet against the crowd you're probably going to be right at least more often than not.

I read an interesting article on the British attitude to investment in America. Certainly contradicts all the crap you read about why it is that people invest in this

country. The British pension funds said we're going to invest in America because America is being socialized and the time to invest in real estate is just before a country flips into socialism because at that point you have a monopoly. Because there will no longer an entrepreneurial incentive to create additional supply. He said it worked beautifully in England, it worked well in Germany, it worked well in Italy, why wouldn't it work in the U.S.? America is in that era in which it's moving into Socialism and that gives us our best advantage on big buildings. There's an attitude which certainly isn't topical. But articulated as an investment strategy. On the other hand, what about oil? We ARE going to run out of oil. The use of the car, ultimately is going to cost you at least \$2.50 a gallon by the year 2,000. Her attitude is saying they're pretty much as before, not bad \$.95 a gallon, why worry? If we have a responsible energy management program and you believe the democratic process is coming around to responsible legislative decisions ultimately, then why wouldn't you have an investment strategy that says hey, the numbers and major regional shopping centers are not a great idea, we really need to bring our shopping back into the neighborhood. Maybe I want to invest in a neighborhood centers where people can walk to and bicycle to and go on their motor bikes. They're not going to buy the damn thing for 20 years

from a pension fund. Investors forgot all about the energy crisis. What is there? Well your first reading is essentially when we run out of oil. When? What are we going to do about electric power? As much as 60% of the power in Chicago is atomically generated. And yet we know atomic power plants are losers, that the life cycle from atomic power plants is negative. It costs more to build it and run it than the power is worth. And there's also some suspicion, obviously, that we're going to have to either replace them or shut them down or find other ways to handle energy conservation. The Sears Roebuck Building (Sears Tower) uses more electricity in eight hours, to take care of 12,000 employees, than the City of Rockford uses in 24 hours. What does that tell you about the rate of obsolescence on a high rise office building. Water has to get pumped up vertically or down, and you have to pump it down because if you let it free fall you'll blow the bottom out of the system because of the vacuum you're going to create from the free fall. A couple of years ago there was an old dormitory at West Point. The cadets wanted to make sure it got renovated and it didn't look like the government was going to do much to bring it back into the 20th Century so they all got together - got their stop watches out, and flushed all the toilets in the building at the same time and absolutely destroyed the plumbing system from the vacuum

created. So whatever goes up likely with pumps and so forth has gotta come down the same line.

Ever think about what, if building futuristic, what's your premises about the future? And how far out are you taking the premise? Think that before? It starts to get you thinking about hey what happened when the baby boom moves through, who's coming behind to buy that house of the same size cohort. Ain't nobody coming through to buy that house of a cohort of the same size. Elderly housing, build a great project up in the Alma Center someplace. What do we have eight units up there or 15? I can't remember. That's great right now, because there are some folks that really need that up in Alma. But Alma is dying, the young people don't stay there. Who's going to be the old folks there at the end of that 40 year mortgage? Or for that matter, what's their housing quality going to be? How many thousand units do we have in the State currently under Section 8 housing? (Refers to the student) You're the expert on that. 15-16,000? Yes. Section 8er's? ...OK most of those are elderly following 10-11,000 of our elderly housing in which folks, are permitted to live at whatever 30% of their income may be, and the federal government pays the difference. Most of those guys are under contracts which begin to expire in what six to eight years, probably phase out in 12 - haven't the foggiest idea in government what they're going

to do to house those elderly. Who can not afford to be in homes alone. The investor's objective is to come out from under the hat plan of the Section 8 and have a well built, well-located apartment of about 550 sq. ft. that he can now rent in the market place at \$600-\$700 a month depending on where you are--does it exceed the income of any of the renters. Who's wrong? What's the investor's expectation down stream? Are you simply going to hold the government up on eminent domain and say fine baby if you want it back for those folks, you can buy it back. That's strategy. Real estate is based on futures. Some of those are mushy, some of those are known, we know how many folks there are going to be at certain age at a certain point in the future, because they're here now. We know about the folks that are elderly and can't afford housing. How many saw 60 minutes the other day? One of their features was the fact that the middle age class are homeless. Middle class can't afford an apartment in New York. A guy with a \$20-30,000 job as a computer operator whose wife died from a terminal illness wiped out their savings of \$30,000. Cost him his job at the same time. Can't afford to rent a place. Living in a public shelter and happy to have it. We've got some premises about the future hope and we spend so much time extrapolating cash flows that we tend to do that in a vacuum. We don't look at the context, that we anticipate

five years down stream, ten years down stream, fifteen years down stream. Appraisal idiots are taking the current cap rate at what the shopping center is 9% and saying gee, you know that's going to be such a desirable investment ten years from now we'll cap the terminal factor at 8 1/2%. Most all of the projects syndicated in 85 and 86 in Madison, by a couple of our local apartment developers, have negative net worths today--they are not worth the price of the mortgage. Price determines conventional cap rate. They've survived because they've got a 30 or 40 year commitments from 221D loans which are artificial mortgages and hopefully their cash flow will cover the mortgage payment. But at some point people will pay 25 or 30% of the value of that mortgage. It was a \$3.0 million mortgage, there was \$900,000 of equity that went into that project, theoretically--most of it went into the pocket of the syndicator and that project probably has a negative net worth of (\$600,000). A year and a half, change the tax law, change some premises about rent control and the overall supply of housing, some folks who don't want to live in apartments and you have a \$1.5 write down on the nominal value going in on that project in a year and a half. Things are getting tough. What was the hope of the guys going in? The hope was relatively short term, they don't look at the balance sheet at all, they simply said wow, look at the tax

shelter. I don't have to pay taxes this year, next year or the year after that--terrific. Now he would have to pay a capital gains tax on their loss because if Uncle Sam says, if you're released from the liability that's tantamount to constructive receipt or sale of the balance that you owe. They can't let go of that project now. They took all of their accelerated depreciation and all investment tax credits up front, and if they don't feed that little piggy even if it's bleeding, Uncle Sam is going to charge you more than the cost of carrying the project. One of the results, you have to have some sense of hope. Its true King said life is a series of short runs, but then that says something about the professional real estate operator. The professional real estate operator, unless he deals with large amounts of equity tends to make life a series of short runs 'cus he goes for the fee, not the investment. What's the fee to building the project, what's the fee of managing the project, what's the fee of syndicating it and securitizing the project, and what's the fee of brokering the project, what's the fee of leasing the project, what's the fee getting insurance, and they say, my God I don't want to own it. The real pro doesn't own anything today but tries to structure his deal so that if for some reason (I'm foreseeing to him) that equity goes up in value he can share on the upside. But otherwise he can take a walk.

Typical investor in real estate--equity investment particularly in real estate--as an individual, really doesn't have a sense about what he's really doing. Real estate is eventually tied obviously to market. Future money markets, and therefore, in many ways is in a macro context rather than a micro context. We spend a lot of time in feasibility being concerned with the micro context as it relates to the building next door, how does it relate to the folks within a mile and a half that might want to live there, etc., etc., but it ultimately the value is in a macro context.

As somebody pointed out in Tokyo and Bonn (Germany), don't like Reagan. They don't have to support the next Treasury rate, and interest rates will move before the 88 elections, and the recession will start before the 88 elections, in other words fall into their debt. Think about that. It came from Soloman Brothers at a swaree for their economist Kaufman. Kaufman is saying that interest rates will be 11% to 11.5% by the third quarter of 88. What does that tell you about the retail prices in real estate? Do you, as a political agency operating simply within the corners of the U.S., have much to think about the interest rate any more? You've got a trade deficit in which people own your butt, and you got a federal deficit in which those that will buy your bonds own your butt, and the real estate

interest rate is going to be a function of whatever that is with a considerable loading. And what you pay for money, is going to determine what it is you can pay for the property. Because suddenly in the industry say hey, it's not loan-to-value ratios its debt-cover-ratio. And therefore, you need more equity and less debt. Indeed in uncertain times as Mr. Drucker will point out in one of the articles that you are reading, you're going to think, "Gee where does Graskamp get off with it, there's nothing in that real estate of value at all." Mr. Drucker points out that any enterprise in a period of uncertainty the objective is not profitability, its liquidity. Liquidity gives you the flexibility to survive, and the liquidity need of any enterprise, particularly in a point of inflation and also at a point of uncertain sales increases each year, because most of the cash for business earned cannot be paid out in dividends, but it is in fact needed to continue the enterprise. It's the working capital of the enterprise. And you need to read the real estate magazines and they're saying to builders hey, where are all builders that created last time? Well, the builders crashed because they were carrying inventory in land. They were carrying inventory in unfinished tenant estates. Dump it, now pay options on land at lower prices two years from now. The recession is going to begin in 88 or 89 depending on who you listen to, and

when that happens, nobody is going to be buying houses, therefore, that land inventory is going to be a millstone around your neck, so get rid of it. We tend to use ratios and goals that may not in fact be relevant to our hopes or to future realities for that matter. Real estate investment is relatively passive and long term. Real estate development is exploitation of a short term opportunity and spread - - - arbitrage if you will.

The essential strategy for the real estate investor is to increase his spread and he has only essentially two ways to do that says Sam Zell. He can enhance the monopoly character of his property and therefore, enhance his revenue. Or he can reduce his costs, including the costs of funds. Active investors--developers--they create their spread through opportunism at the micro level--buy low, sell high, etc. Exploiting inside information if you will. Pretty radical - in the stock market exploiting inside information is illegal. But it's the heart of development. It's knowing who's about to move from where and being there first. It's useful to know from a secretary that her president is thinking about moving their corporate offices. Nobody goes to jail for finding that out. The guys who lease, they know everybody in the front office. And, of course, it's useful to know that you're going to enjoy the income from what you're going to do. Half of investors on

the other hand enhance their spreads because of timing and because of their ability at arbitrage, typically between the money markets but sometimes between the skill markets. You'll see it in some of your readings, for example, Olympian and York, moved into New York and took Uras Corp. off the hook. Uras has built some major office buildings just when the market swooned in New York. They were in cash flow problems and they had a number of other crises in terms of the tenant or two that went bankrupt and moved out, and they bought Uras at a ridiculously low price per sq. ft. So they bought portfolios of it, 2, 3 million sq. ft. at prices considerably below \$100 a sq. ft. Five years later, the market sails and they're speculating in a commodity called square fee of Class B office space. By the time the market had stabilized again, what they were buying at \$35 to \$40 a sq. ft. in New York City was worth \$400 and \$500 a sq. ft. That's a quick way to make money, particularly if you do several million sq. ft. at a time. They estimated that one transaction made them \$5 billion and a couple of other businesses put together in the pact. Passive investor though, now the passive investor obviously needs to manage the property, but he's enhancing it because he can operate on a timely basis--buy low, sell high and because he can arbitrage perhaps reaching money markets that others can't reach. Classic example being the person, current CMO's, in

which, the poor bastard that's buying his house retail is paying 10.5% interest rate on the whole mortgage, but the guy who buys the portfolio goes into the money market investing in the Treasury curve and is able to come up with an average interest rate of maybe 6.5% and credit enhancement that adds another one point, now he's got a cost of funds at 7.5% versus the guy who's at retail at 10.5% and it's an unequal spread, the present value of that works out real well. So he's arbitraging, but he is still a passive investor, he hasn't seen a single one of those houses, never sold a thing in the house, never paid a single mortgage, but his timing is good and his arbitrage is good. So the essence of strategy and taxes for real estate fall back to passive investments, it's really exploiting institutional and technical details of the appropriate time in order to achieve a spread. Shidler, when he's here, will talk about that. He's a consummate artist at operating within the technical details of the FASB (Financial Accounting Standards Board) rules. Creating fictional profits for corporations while he steals their millions.

One of the problems of course with, going back to passive investors, is that the relationship to real estate creates an emotional vector, a creative-urge if you will, and it means that it's not always as rationally efficient as the folks in the theoretical finance courses would like to

believe. Psychic income is a significant source of return in real estate. You can try to buy it, you can put your thumb in your suspenders and say it's fine. And that's good for at least 1% on the cap rate. That's probably true - more true of real estate than any other kind of capital intensive kind of investment strategy. It's very hard to fill your pride in a stock that you bought or a bond or commercial paper note, you generally don't leave it out on the coffee table and talk smartly about it at the cocktail party.

Oh while we're talking about guest speakers, by the way, 785, I've got three out of four set down on the date if you want to write those down, if you're in the feasibility course you may want to write the dates down. All three of these will be at the Edgewater in the upper auditorium. Forgive me if I work backwards, but it's the way I remember them the best at the moment. April 29, will be Steve Jarchow, talking about real estate investment fund formation and specifically a Lincoln Properties thing which should be fun simply because it has so many twists and turns applied to it, it might as well be a novel and then April 8 will be Jay Shidler talking about how he does it. He should be a role model for all of you in that his first project was an assignment in the principles of real estate class with Don Allen, and a few of us had a good idea and said why don't

you go see so and so, a Japanese appraiser and investor in Honolulu and he did that, and he said gee that's a great idea Jay, let's go 50/50 which they did, and he had made his first killing before he finished his junior year at the University of Hawaii and came up with a very ritzy leverage formula. As a result the Shidler Company has seven partners around the country, by the way, but it's all for the greater glory of Fritz Shidler, had outside partners investing and so forth, it's all for the house account and they do not ever put their own money into a deal. And he might provide a little noted endorsement of what they perceive as a non-risk. But otherwise they do extremely well and have hundreds of millions of dollars in real estate now with no money down. And they aren't dealing in shacks down in the student quarter, we're talking about major industrial parks, office buildings and so forth. But at any rate he'll be here on the 8th. Very different corporate culture, very different view of real estate investment. The one before him will be on March 25, will be Todd Mansfield, and probably his boss, Bill Renal, of Disney Development Corporation and they do all of the so called non-gate real estate. And the first one and the one I still haven't got them nailed down to as to the date, it will either be the last Friday in February or the first Friday in March, will be Jerry Clay of JMB with a couple of his associates doing

the Cadillac Fairview deal for about six hours, it's about all that you can stand although he will probably just scratch the surface and which has been the largest real estate transaction to date in the history of world, other than the possibly the first seven days, so that program is pretty high powered. So they're all looking forward to it and at this point all of the three that are scheduled will be at the Edgewater, I can't say for sure about the last one.

Given our basic introduction to the mush of real estate investment the first eight readings are really some comments on the futurism of energy, the futurism of political and social trends, interesting comments out of the Economist Magazine on entrepreneurship, hope and strategy, and the possibilities of the future, demographically and otherwise. You'll find an article by George Sternlieb (or Steinlieb) that's interesting about the fate of the state. The major cities, he says today, are the home of the transfer payment. All citizens are virtually moved out, and that employers are likely to follow. The second section is essentially starting to say, gee, what is the strategy, what are some of the elements of strategy that the readings (end of side one) and the readings will begin to look at that. Japan will be telling you about core portfolios and the British will be talking about the socialism of America and the opportunity

for monopoly, and other investors like Coldwell Banker and so forth and so on will have other concepts of what they think the play is so far as they want to tell you. Obviously, none of them have an exclusive on any of it, but it certainly begins to suggest to you the infinite variety of investment attitudes, replaces the subject really of your hopes and expectations of the future that may be there. The other element of that will be looking at economic scenarios about the future. Begin to read whatever you see in the papers and perhaps some of the other books on futuristic looks at the coming depression in 1990 and other messages of hope from other authors and you have a number of scenarios which you're really going to have to in your own mind, kind of establish the premise on which you are operating. The popular choice, of course, is that most industrialism in the U.S. is going to go into a smooth transition into its new economic role of somewhat less significance world wide than before and that we will be able to resolve some of our social and political problems. That we'll have a steady economic growth with a few brief recessionary slow downs, but that they will be survivable, at least by the middle class. Those at the bottom of the economic structure will have a tough time of it. They will have gradually declining unemployment and that there will be some shift away from manufacturing toward other kinds of service enterprises and

so forth. This is socialism of one form or another. That growth always solves the deficit or the debt problems and you notice the Republicans are always talking the only thing we need to do is have lower interest rates and prosperity will then correct all social ills, and so forth, and the Democrats are of course taking the other view the only thing that will work is subsidy and taxes to the rich to subsidize the poor. And finally it worked that real interest rates will be relatively low and moderate during this decade of transition into the millennium.

The second alternative scenario would be something like this that we're going to have a somewhat erratic transition. The transition to the new economic United States is going to be interrupted by some recessions that are comparable to the 70's and we'll be a little Raggedy Andy. That economic growth is erratic with some spurts interrupted by stagnation or negative growth, staggering unemployment will move from 7% to 12%, it will be somewhat regional. There will be continued pockets of unemployment and indeed maybe some pockets of outright rebellion in areas that are not barring or getting their fair share of economic opportunity. Debt loads, for example, remain high with considerable default rates and there will have to be considerable rescheduling of repayments to protect the credibility of our financial institutions. That's already true. Twenty-five to fifty

billion dollars in losses in the savings and loans. The entire savings and loan industry have a surplus of barely 2% of the total deposit. And some 5-600 of them are already bankrupt and we can't afford to close them because FSLDIC is itself bankrupt. The problem is less severe in the banks because the banks don't have to report what their losses are since as long as there's a possibility of repayment, the accounting statement does not have to reflect the underlying value of the assets and it continues to reflect the amount of the note or their debt reserves being only as what they perceive to be the reduction in how much they will collect from the note. Again, it's an erratic scenario with its assumed pressure to control government deficit will continue increases in tax rates and increasingly severe spending adjustments. Certainly some talk of that presently--if that's not what the presidential election's about, I don't know what it is about. The board leader stood up and said we only got two ways to go baby and that's one, raise taxes and two, reduce deficits. Where are the hot areas right now? If you look in the book about attitudes, Boston, New England- - Wow, that is the place to invest. What's been responsible for doing with the come back? They get more defense dollars per capita than other part of the United States. Why do they do that? For every congressman and senator position aspiring chairmanships and sub-

chairmanships are concerned. But if, in fact, we do have a budget direction, what's going to get cut?--defense. Set the gold industry at the market. ? Maybe the miracle of the Northeast isn't quite such a miracle at all, it just may be that they get enough federal dollars out of Uncle. Will real estate interest rates moderate gradually as deflationary forces, because of excess capacity decline and debt loads keep pressure on borrowing? What about our trade deficit? If we allow interest rates to fall, what happens? Less foreign capital comes over here because at that point the spread between the opportunity cost here and someplace else is less--and they might as well take their money home. So the erratic transition scenario isn't necessarily a very good one for real estate. It may benefit some, it may benefit others. The dollar continues to fall, some jobs will come home. I think it was Tandy, it was reported that they were bringing all of their computer factory operations back from Korea to the U.S., particularly the Southwest, because the labor factor was now cheaper in America's Southwest than it was in Korea. The trade balance, the dollar and so forth and so on. But notice it comes back to none unionized, none structured labor pools which can continue to be exploited. Now what the data implied relative to the new immigration act which if it is enforced starting in '88, means there's isn't going to be enough hope

to pick your cabbages and your melons and so forth, or work in your electronics plant. Things work together? The institutional framework from which real estate operates is extremely ?? (don't understand) and extremely broad.

The third scenario, of course, if you're a pessimist is we actually have economic destruction, that we might have significant default on foreign and domestic loans. That we never will get our government deficit under control. And that we eventually will have to have drafted drastic control measures, a real austerity program. Period of rising unemployment concentrated particularly in the traditional areas of defense and manufacturing. Obviously spreading ultimately to other industries as well. Real interest rates will have to remain high for most of the 1980's, one to deflect against inflation and two to protect us against a run on the dollar by overseas money.

Four, we will have social disruptions in our cities where we have 25% of our population now in poverty. The number and percentage ratio and absolute number of poverty has risen under the Reagan administration rather than decline. And they're getting restless. Question is, can we keep them drugged long enough so they don't fight, it's a real question. Which of those social scenarios, economic scenarios do you want to take? We should begin to influence then your view of real estate--and real estate investment

versus development. Exploitation of the opportunity of the short term Keynesian active investor, or whether in fact as a portfolio investor you have to be fatalistic and say gee, I need diversification because I don't where lightning is going to hit next. But they can't all fall down at the same time. But to what degree is the systematic risk that the stock investor likes to talk about, beginning the task, perhaps carries much more significance than the nonsystematic risks which can be relatively easily stabilized in real estate.

And so we begin real estate investment by having to make a fairly mushy set of assumptions about the future context in which one operates. Keeping one eye to the leeward, as it were, and having a hope about the future, or otherwise you're going to the CD's and Treasuries and the mason jars in the back yard. Think about that. What is the hope, what's the framework within which we're now going to build a rationalized systematic method of selection and management and presumably increase of our net worth. If we look at the rationalized nonpsychic income benefits of real estate its only two things--one, increase our spendable income, or two, increase the net worth that we can benefit from in our life time and pass on to the next generation. The most significant thing Reagan has done is to allow the middle class to pass on their net worth, by raising the

exemptions significantly on the federal estate tax so that it can pay us more or less in tax with the minimum liquidity exposure for the next generation. We'll begin to look at that as the semester progresses. How do we improve our spendable cash, how do we improve the liquidating value of our net worth so we can transfer, in this life or the next, to whatever cause or purpose we wish. Okay, we'll come back to that. (end of tape)

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Week 1

In your mimeograph packet there will be ultimately proposals to the 87 law, Tax Matters in Real Estate. What you know from one semester to another are relatively classic. First of all relative to the text book we do have Stuper and Theater at the bookstore. I advise you to get the book as it will help you to pull things together. For those of you who haven't to this point, you'll probably find it redundant. Four or five of the chapters are on the 1982 tax law which unless you're into history the thing is useful. Initially they were going to have their new addition out but knowing Hoover and Here, they happen to have till next Sept. as the earliest. So I have completely rebuilt the syllabus and plagiarized a good many additional readings which we'll adjust to the changing industry here, and the change in the tax laws and the change in the institutional investment and changes in structuring and so forth which is going on presently and try to make it as current as possible with readings up through Oct. and Dec. of 87. Including some excerpts from several new books that are out. Three chapters from the new book Riches into Ruin in Real Estate with Jim Powell who is a New York Times finance reporter that has so far one of the big players in real estate, a make a deal maker and I think its a pretty interesting book. Its organized in such a way that it will give you some different ideas about areas of expertise such as construction management and the skills involved in that. Lookingat liability, there's a whole chapter on the Kansas City disaster at the Hyatt and implications of that and so forth, which has had some pretty guilty implications on structuring pension funds and global liability move through and so forth and so on. Some of the players some of the disasters, the near disaster of Travell Crow and the resulting restructuring of Travell Crow to take control away from Travell and put it in the partners that are coming along and might cause internal friction. And also I think the new names involved as to who the big players are and what kind of folks they are. So anyway, its an interesting book that has been assigned for a little extra reading. We also have Natalie McKenties book on Pension Fund Investment, we've taken several chapters out of that relative to pension funds strategies, mistakes, opportunities and so forth. A wide selection of alternative sources of material which is one of the purposes of government to testify the use of direct variety of literature that's available and then organize that by subject matter. We'll probably expand on that as appropriate. The second thing we need to have is Mark Eply is a TA in

the course, specifically for 17 year case studies onto the computer. He'll be a computer resource as well as a computer instructor for you. Mark's spent a lot of time and he's been poking around with Mike Robbins and trying to find somewhat different format for computer use and here one of your problems is your problems is going to be choosing probably the appropriate software package that allows you to get the job done and address the real issues both particularly and at the same time we want to you take a look at a program called project, some of you are already familiar with it and the project people are very nice and allow this series of copies which will be locked into the hard disc machines upstairs, left ten of them set up for you upstairs with manuals and so forth. Its a lase by lease program as well as a fairly sophisticated current tax program, but it also has a program called Dynamis, which then allows you to move through the base cash flow and start constructing matrixes of whatever ratios it is you think are relevant whether just simply getting what the program provides or doesn't provide, its also gives you an opportunity to structure and decide whether a partnership or a corporate shell or whatever might be more desirable at least from a financial standpoint, not necessarily on other factors. It is probably a program that's taking over out there in the industry. Finsim II has had its day, which has died, it has not been adequately changing tax laws, not necessarily changing pace with changing attitudes as real estate investors change whats important in terms of financial analysis and project is, and I think once you get out there, a significant percentage of investors are using project in-house if they don't have their own system relative to the property quite similar. It is a program which sells for about \$6,000 and we have, therefore, taken precautions to protect it and the manual, so please respect that. They have given us about \$60,000 worth of software. We'll protect our tail feathers by 71. We also have another program call DNA which has a much more elaborate state tax model, looking at what different states would tax real estate for, which is now often considered in the investment courses which the federal laws and all of the 73 and so on. And in this course while we will down play a little bit the income tax advantages, its not as much of a game to play anymore, the real game is the estate tax law, the inheritance tax process, and therefore we will spend more time on that aspect of real restate and structuring to minimize the friction through the process and minimize the tax burden on the process and looking at real estate as a wealth transfer device from generation to generation as well as a wealth generation developer for the initial older investor. And the course will be split approximately six weeks on the individual investor side, about six weeks on the institutional investor's side and then about six weeks looking at the new media in terms of what REITs are doing and NLBs and whatever. What are the pros and cons. As many of you know, my favorite questions on the final are typically matrixes which say okay guys, here's five different structural frameworks for the real estate and here's twelve attributes relative to liquidity and control and risk and so on, and you know now compare and contrast on my little grid and matrix and so forth. So I'm going to give you a way to kind of organize you thoughts and boiling them down to the critical element. Okay. The two statutories that we have are on the syllabus, one is courtesy of the equitable and the other is not the courtesy of the 93. The reading packet is relatively enormous. It should be available by late Friday or early Saturday at Bob's at the corner of Randall and Johnson. I threw out about four and half inches. And I added about ten. So even if 40% remain from last year there's only 20% of the new pile. In the process I had very interesting conversations with 105 authors, Gary Cooper and Mike Farrow and Dale Ingrea, who have a new book out on real estate investment and so forth. And the problem is what they call real estate

investment we teach in 550 and 551. And have gone well beyond their textbooks for that. We got talking about Kenneth Rutherford and Dan Ross out there and Stan Ross says gee, that would be Monday night and we're kinda thinking about doing something slightly Kenneth Leventhol and coming out with a real estate investment text or at least Don Hollick or somebody that would cover the need, because there's just nothing out there, there really isn't so I apologize for three pounds of mimeograph and so forth. Them's the conditions what prevail. And what is a very rapidly moving area. In fact if any of you are thinking about coming professors I recommend that you consider serious ancient history where materials so not change substantially from the time you're a graduate student until your on select. As long as you don't remain legible you're in business, but I have about four pamphlet files of notes for this course which are no longer relevant and I think I will hold ancient history in my next life cycle and if anybody finds an old scroll I will deny it as a fraud and continue forward. Now, let's talk a little bit about real estate investment. There is a tremendous gap to meet supplies in hiring about teaching real estate investment in terms of the detail and complexity and presumption of rational systems that we have here because ultimately investment in real estate is simply a statement of hope. Think about that. Its really ironical that we spent that much time rationalizing something which essentially and ultimately is an irrational move. It is based on hope. You have absolutely no empirical reason for doing what you're doing other than whatever system comes to mind at the moment. Think about that--its really ironic, we're making comments about a 15 or 20 or 30 year investment which presumes essentially that the social and cultural and technical elements will move forward at an orderly pace and to the degree that there's change there will be plenty of time for you to improvise and adjust accordingly and of course, you have internal piece of garbage that says change always provides opportunity for creative advantage. Phewy. Find a creative advantage in a ranch for a real estate investor. You really need to look for the implicate assumptions which are statements of hope and hope is what you're building the whole damn thing on. And therefore, you really begin as a real estate investor the statement of age about people and politics and about systems and technology and that's the context in which you're operating, and that's pretty mushy. To do financial ratios two decimal places when the whole damn thing rests on whether somebody is going to shoot at somebody in the Persian Gulf, its insanity fundamentally and blatantly. What you're really doing is you're making a commitment on faith and then rationalizing it so you feel good. Its a strange statement to make in a finance course in which we're going to worry about punching numbers and decimals 1% rate of return and so forth and so on, it just isn't there. Deep down underneath there are building and shifting sands in which you're made a statement about faith. Real estate ultimately is a religious experience. What may happen is all futuristic and its all extrapolating what we think we know. We move from irrational hope to towards some sort rationalized attitude, then ultimately we come up with a intellectual strategy that says hey, all things considered this isn't bad, this is--if Reagan uses the Neutron bomb well at least the real estate will survive. So in any event we have the basic dichotomy that at some point real estate investment is a leaping assumption about the future and our ability to adjust and survive in a changing world. One that helps that in the past was that how long is the time line of hope? We can have hopes that are three years long or hopes that are 25 years long and what's the time line of the hope? In some ways that's a very forgiving kind of thing. Pension funds 170 with their capital than you who will starve if you don't flip the property within a few moments of the time of closing, but nevertheless we need to know what is the time

line of hope. What's the time line of the pension fund versus the home buyer? How much does he have to rationalize, and what's his downside in terms of his hopes? And one thing we need to be aware of is that in our approach to trying to get a handle on our hope and structure that into some sort of rationalized attitude, how often are we being infected by tropical attitudes, short term kinds of things? Investing against the tide is one premise, everybody's wrong therefore, if they're buying, I'm selling, if they're selling, I'm buying, sort of thing that's certainly a statement about a topical attitude certainly the contrarian position and his saying that essentially that you go against the crowd you're probably going to be right at least more often than not. I read an interesting article on the British attitude on the Americas. Certainly counterfactual in fact you read about why it is that people invest in this country. The British pension funds said there, we're going to invest in America because America is being socialized and the time to invest in real estate is just before a country flips into socialism because at that point you have a monopoly because they there will no longer an entrepreneurial incentive to create additional supply. He said it worked beautifully in England, it worked well in Germany, it worked well in Italy, why wouldn't it work in the U.S.? America is in that era in which its moving into Socialism and that gives us our best advantage on big buildings. There's an attitude which certainly isn't topical. But articulated as an investment strategy. On the other hand, what about oil? We are going to run out of oil. The use of the car, ultimately is going to cost you at least \$2.50 a gallon by the year 2,000. 201 her attitude? Her attitude is saying they're pretty much as before, not bad .95 a gallon why worry. If we have a responsible energy management program and you believe the democratic process coming around to responsible legislative decisions ultimately, then why wouldn't you have an investment strategy that says hey, the numbers and major regional shopping centers are not a great idea, we really need to bring our shoppers back into the neighborhood. Maybe I want to invest in a neighborhood centers where people can walk to and bicycle to and go on a motor bike. They're not going to buy the damn thing for 20 years from a pension fund. Forgot all about the 212. What is there? Well you're first thinking is essentially when we run out of oil. How do you when? How do you plan? Who do you know that went to college? As much as 60% of the power in Chicago is atomically generated. And yet we know atomic power plants are losers, that the life cycle from atomic power plants is measured. It costs more to build it and run it than the power is worth. And there's also some suspicion obviously that we're going to have either 220 or shut them down or find other ways to handle energy masterly. The Sears Roebuck Building uses electricity in eight hours to take care of 12,000 employees that the City of Rockford uses in 24 hours. What does that tell you about the 223 on the high rise office building. We either are going to have to get pumped up vertically or down and you have to pump it down because if you let it free fall you'll blow a 225 out of the system because of the vacuum you're going to create from the free fall. A couple of years ago there was a old dormitory at West Point. 227 make sure it got renovated and it didn't look like the government was going to do much to bring it back into the 20th Century but what does all of that get after 229 at the same time and absolutely destroyed the plumbing system from the vacuum created 231. So whatever goes up likely comes down the same line. Ever think about what, if building futuristic, what's your premises of the future? And how far out are you taking the premise? Think that before. Now starting get you thinking about hey what happened to the baby boom moves through, whose coming behind to buy that house of the same size cohort. Ain't nobody coming through to buy that house of a cohort of the same size. Elderly housing it would make project up in the Alma Center

someplace. What do we have eight units up there or 15 I can't remember. That's great right now, because there are some folks that really need that up in Alma. But Alma is dying, the young people don't stay there. Whose going to be the old folks there at the end of that 40 year mortgage? Or for that matter, what's there housing quality going to be, when how many thousand units do we have in the State currently under Section 8 housing. You'll be the expert on that as well. 13-16,000 Section 8er's...most of those are elderly following 10-11,000 of our elderly housing in which folks are permitted to live at whatever 30% of their income may be, and the federal government pays the difference. Most low guys under contract which begin to expire in what six to eight years, isn't the foggiest idea in government what they're going to do with the house 259. The investor's objective is to come out from under the hat plan of the Section 8 and have a well built, well located apartments of about 550 sq. ft. that he can now rent in the market place at \$600-\$700 a month depending on where you are--does it exceed the income of 265. Whose wrong? What's the investor's expectation down stream. Are you simply going to hold the government up on eminent domain and say fine baby if you want it back for those folks you can buy it back. That's strategy. Real estate is based on futures. Some of those are mushy, some of those are known, we know how many folks there are going to be at certain age at a certain point in the future, because they're here now. We know about the folks that are elderly and can't afford housing. How many saw 60 minutes the other day, one of their features was the fact that the 274 are homeless. Middle class. Can't afford an apartment in New York. A guy with a \$20-30,000 job as a computer operator whose wife died from a terminal illness whipped out their savings of \$30,000. Cost him his job at the same time. Can't afford to rent a place. Living in a public shelter and happy to have it. We've got some premises about the future that we spent how much time extrapolating cash flows that we tend to do that in a vacuum. We don't know what is the context that we anticipate five years down stream, ten years down stream, fifteen years down stream. Appraisal idiots are taking the current cap rate at what the shopping center is 9% and saying gee, you know that's going to be such a desirable investment ten years from now we'll cap the terminal factor in half 287. So all the projects syndicated in 85 and 86 in Madison, by a couple of our local apartment developers are of negative net worth today--they are not worth the price of the mortgage. Price determines conventional cap rate. They've survived because they've got a 30 or 40 year commitment from 221D loans which are artificial mortgages and hopefully their cash flow will cover the mortgage payment. But at some point it will take 25 or 30% of that mortgage as quickly as our mortgage that was \$900,000 of equity that went into that project theoretically--most of it went into the pocket of the syndicator and that project probably has a negative net worth of \$600,000. A year and a half, change the tax law, change some premises about rent control and the overall supply of housing, because most don't want to live in apartments and you have a \$1.5 breakdown on the nominal value going in on that project in a year and a half. What was the hope of the guys going in? The hope was relatively short term, they don't look at the balance sheet at all they simply said wow, look at the tax shelter. I don't have to pay taxes this year, next year or the year after that--terrific. Now he would have to pay a capital gains tax on their loss because if Uncle Sam says if you're released from the liability that's 312 enough to construct your proceed or sale at the balance that you owe. They can't let go of that project now. They took all of their accelerated appreciation and investment tax credits up front and if they don't feed that little piggy even if its bleeding, Uncle Sam is going to charge you more that the cost of carrying the project. One of the results, you have to have some sense

of hope. Its true king said life is a series of short runs, but then that says something the professional real estate operator. The professional real estate operator, unless he deals with large amounts of equity tends to make life a series of short runs and he goes for the fee, not the investment. What's the fee to building the project, what's the fee of managing the project, what's the fee of syndicating it and 325, and what's the fee of 326, what's the fee of leasing the project, what's the fee getting insurance, they say, my God I don't want to own it. The real 328 doesn't own anything today. I'm trying to structure the deal so that if for some reason I'm foreseeing to him and equity goes up in value he can chair up the upside. But otherwise he can take a walk. Typical investor in real estate--equity investment particularly in real estate--as an individual, really doesn't have a sense about what he's really doing. Real estate is eventually tied to the fair market value. Future money markets and therefore, in many ways is in a macro context rather than a micro context. We spend a lot of time in feasibility being considered as the micro context as it relates to the building next door, how does it relate to the folks within a mile and a half that might want to live there, etc., etc., but it ultimately values as a macro context. As somebody pointed out in Tokyo and Salem, Germany, don't like Reagan. They don't have to support the next Treasury rate and interest rates will move before the 88 elections and the recession will start before the 88 elections, in other words fall into their debt. Think about that. It came from Salomon Brothers swaree 351 is saying that interest rates will be 11 to 11.5% by the third quarter of 88. What does that tell you about the retail prices in real estate. Do you as a political agencies operating simply within the corners of the U.S. have much to say about the interest rate any more. You're got a trade deficit in which people own your butt, and you got a federal deficit in which those that will buy your bonds own your butt and the real estate interest rate is going to be a function of whatever that is for a considerable loan. And what you pay for money, and they determine what it is you can pay for the property. Because several in the industry say hey, its not loan to value ratios its debt cover ratio. And therefore, you need more equity and less debt. Indeed in uncertain times as Mr. Drucker will point out in one of the articles that you are reading, you're going to say gee where does man get off with it, there's nothing in that real estate of value at all. Mr. Drucker points out that any enterprise in a period of uncertainty the objective is not profitability, its liquidity. Liquidity gives you the flexibility to survive and the liquidity need of any enterprise particularly in a point of inflation and also at a point of uncertain sales increases each year, because most of the cash for business earned cannot be paid out intuitive, but it is in fact needed to continue the enterprise. Its the working capital of the enterprise. And you need to read the real estate magazines and they're saying to builders hey, where are all builders drag last time. Well, the builders dragged because they were carrying inventory and land. They were carrying inventory in unfinished 379. 380 now paid options on land at lower prices two years from now. The recession is going to begin in 88 or 89 depending on who you listen to and when that happens nobody is going to be buying houses therefore, that land inventory is going to be a milestone around their neck, so get rid of it. We tend to use ratios and goals that may not in fact be relevant to our hopes or to future realities for that matter. Real estate investment is relatively passive and long term. Real estate development is exploitation of a short term opportunity and spread. Arbatragae if you will. The essential strategy for the real estate investor is to increase his spread and he has only essentially two ways to do that says Dansville. He can enhance the monopoly character of his property and therefore, enhance his revenue. Or he can reduce his costs including

the costs of funds. Active investors--developers--they create their spread through opportunism at the micro level--buy low, sell high, etc. Exploiting inside information if you will. Pretty radical in the stock market exploiting inside information is illegal. Its the heart of development. Its knowing whose about to move from where and being there first. Its useful to know from a secretary that her president is thinking about moving their corporate offices. Nobody goes to jail for finding that out. The guy who leads, they everybody in the front office. And, of course, its useful to know that you're going to enjoy the income of what you're going to do. Half of investors on the other hand enhance their spread because of timing and because of their ability at arbitragae, typically between the money markets but sometimes between the 427 markets. You'll see it in some of your readings, for example, the wife is an Olympican 428, moved into New York and took Uras Corp. off the hook. Uras has built some major art facilities just when the market swooned in New York. They were in cash flow problems and they had a number of other crises in terms of the ten or two that went bankrupt and moved out, and they bought Uras at a meticulously low price per sq. ft. So they bought portfolios of it, 2, 3 million sq. ft. at prices considerably below \$100 a sq. ft. Five years later, the market sails and they're speculating it to come at a sq. ft. of class B office space. By the time the market had quickly widen again, what they were buying at \$35 to 40 a sq. ft. in New York City was worth \$400 and \$500 a sq. ft. That's a quick way to make money particularly if you do it several million sq. ft. at a time. They had to make that one transaction made them \$5 billion and a couple of other businesses put together the pact. Passive investor, now passive investor obviously means the 449 that manages the property, but he's enhancing it because he can operate on a timely basis--buy low sell high and because he can arbitragae perhaps thinking money markets that others can't reach. Classic example being the person current CMO's in which the poor bastard that's buying his house retail is paying 10.5% interest rate on the whole mortgage, that the guy who buys the portfolio goes into the money market investing in the Treasury Reserve and is able to come up with an average interest rate of maybe 6.5% better enhancement so he adds another one point, now he's got a cost of funds at 7.5 versus the guy whose at retail at 10.5 and its an unequal spread, it spreads value that what's up or low. So he's arbitragaing, but he still has them and hasn't seen a single one of those houses, never sold a thing in the house, never paid a single mortgage. By the time he did good in his arbitragae. So the essence of strategy and taxes for real estate fall back to passive investments, its really exploiting institutional and technical details of the appropriate time in order to achieve a spread. Sifer when he's here will talk about that. He's a consummate artist at operating within the technical details of the fasby rules. Creating fictional profits for corporations while he steals their millions. One of the problems of course with go back to passive investors is the relationship to real estate creates an emotional vector, a creative berg if you will, and it means that its not always as rationally efficient as the folks in theoretical finance courses would like to believe. Psychic income is a significant source of return in real estate. You can try to buy it, you can put your thumb in your suspenders and say its fine. And that's good for a least 1% of the cap rate. That's probably more true of real estate than any other kind of capital intensive kind of investment strategy. Its very hard to fill your pride in a stock that you bought or a bond or commercial caper note, you generally don't leave it out on the coffee table and talk smartly about it at the cocktail party. While we're talking about guest speakers, by the way, 795, I've got three out of four set down on the date if you want to write those down, if you're in the feasibility course you may want to write the

dates down. All three of these will be at the Edgewater the upper auditorium. Forgive me as I work backwards, but it's the way I remember them the best at the moment. April 29, will be Steve Jarchow, talking about real estate investment plus formation and specifically a Lincoln Properties which should be fun simply because it has so many twists and turns applied to it it might as well be a model and then April 8 will be Jay Shiberger talking about how he does it he will be a role model for all of you in that his first project was an assignment in the principles of real estate class with Don Allen and a few of us had a good idea and why don't you go see so and so, a Japanese appraiser and investor in Honolulu and he did that and he said gee that's a great idea Dave, let's go 50/50 which they did and he had made his first killing before he finished his Junior year at the University of Hawaii and came up with a very ritzy leverage formula. As a result the Shidler Company has seven partners around the country by the way, but it's all for the greater glory of Fritz Shidler, had outside partners investing and so forth, it's all for the house account and they do not ever put their own money into it here. And he might provide a little noted endorsement of what they perceive as a none risk. But otherwise they do extremely well and have hundreds of millions of dollars in real estate now with no money down. And they aren't dealing in shacks down in the student quarter, we're talking about major industrial parks, office buildings and so forth. But at any rate he'll be here on the 8th. Very different corporate culture, very different view of real estate investment. The one before him will be on March 25, will be Bob Mansfield, and probably his boss, Bill Renal, of Disney Development Corporation and they do all of the so called none gate 558. And the first one and the one I still haven't got them nailed down to as to the date, the last Friday in February or the first Friday in March, will be Jerry Clay of Data 566 with a couple of his associates doing the Cadillac Fairview deal for about six hours is about all that you can stand although he will probably just scratch the surface and which has been the largest real estate transaction to date in the history of 572, other than the possibly the first seven days of 574, so that program is pretty high powered. So they're all looking forward to it and at this point all of the three that are scheduled will be at the Edgewater, I can't say for sure about the last one. Given our introduction to the mush of real estate investment the first 587 are really some comments on the futurism of energy, the futurism of political and social trends, interesting comments out of the Economist Magazine on 593, hope and strategy, and the possibilities of the future demographically and otherwise. You'll find an article by George Stringly that's interesting about the state of 599. The major cities, he says today, are the home of the transfer payment. All citizens are virtually 602 and moved out and that employers are likely to follow. The second sector is essentially starting to say, gee, what is the strategy, what are some of the elements of strategy that the readings (end of side one) and the readings will begin to look at that. Japan will be telling you about core portfolios and the British will be talking about the socialism of America and the opportunity for monopoly, and other investors like Caldwell Banker and so forth and so on will have other concepts of what they think the play is so far as they want to tell you. Obviously, none of them have an exclusive on any of it, but it certainly begins to suggest to you the infinite variety of investment attitudes, replaces the subject really of your hopes and expectations of the future that may. The other element of that will be looking at economic scenarios about the future. Begin to read whatever you see in the papers and perhaps some of the other books on futuristic looks at the coming depression in 1990 and other messages of hope from other authors and you have a number of scenarios which you're really going to have to in your own mind kind of establish the premise on which

you are operating. The 21 is that most industrial specific to the U.S. is going to go into a smooth transition into its new economic role of somewhat less significance world wide than before and that we will be able to resolve some of our social and political problems. That we'll have a steady economic growth with a few brief recessionary slow downs, but that will be survivable at least by the middle class. Those at the bottom of the economic structure will have a tough time of it. They will have gradually declining unemployment and that there will be some shift away from manufacturing for other kinds of service enterprises and so forth. This is how 30 of one form or another. That growth always solves the deficit or the debt problems and you notice the Republicans are always talking the only thing we need to do is have lower interest rates and prosperity will then correct all social ills and so forth and the Democrats are of course taking the other view the only thing that will work is subsidy and taxes to the rich to subsidize the poor. And finally it worked that real interest rates will be relatively low and moderate during this decade of transition into the millennium. The second alternative scenario would be something like this that we're going to have a somewhat erratic transition. The transition to the new economic United States is going to be interrupted by some recessions that are comparable to the 70's and we'll be a little Raggedy Andy. That economic growth is erratic with some spurts interrupted by stagnation or negative growth, stager economic employment will move from 7 to 12%, it will be somewhat regional. There will be continued pockets of unemployment and indeed maybe some pockets of outright rebellion in areas that are not barring or getting their fair share of economic opportunity. Debt loads, for example, remain high will considerable default rates and there will have to be considerable rescheduling of repayments to protect the credibility of our financial institutions. That's already true. Twenty-five to fifty billion dollars in losses in the savings and loans. The entire savings and loan industry has a surplus of barely 2% of the total deposit. And some 5-600 of them are already bankrupt and we can't afford to close them because FSLDIC is itself bankrupt. The problem is less severe in the banks because the banks don't have to report what their losses are since as long as there's a possibility of repayment, the accounting statement does not have to reflect the underlying value of the assets and it continues to reflect the amount of the note or their debt reserves being only as what they perceive to be the reduction in how much they will collect from the note. Again, its an erratic scenario with its assumed pressure to control government deficit will continue increases in tax rates and increasingly spending adjustments. Certainly some talk of that presently--if that's not what the presidential election's about, I don't know what it is about. 060 stood up and said we only got two ways to go baby and that's one, raise taxes and two, reduce deficits. What are the 061 rates right now? If you look in the book about attitudes, Boston, New England--Baah, that place is best. What's been responsible for doing with the come back? They could afford a set sense of dollars per capita than other part of the United States. Why do they use that? For every congressman and senator position aspiring chairmanships and sub-chairmanships are concerned. But if in fact we do have a budget direction what's going to get cut--defense. Set the gold industry at the market. 068 Maybe the miracle of the Northeast isn't quite such a miracle at all, it just may be that they get enough federal dollars as an uncle. Will real estate interest rates moderate gradually as deflationary forces, because of excess capacity decline and debt loads 071 on borrowing? What about our trade deficit? If we allow interest rates to fall, what happens? Less foreign capital comes over here because at that point the spread between the opportunity cost here and someplace else is less--and they might as well take their money home.

So the erratic transition scenario isn't necessarily a very good one for real estate. It may benefit some, it may benefit 077. The dollar continues to fall, some jobs will come home. I think it was Tandy, it was reported that they were bringing all of their computer factory operations back from Korea to the U.S., particularly the Southwest, because the labor factor was now cheaper in America's Southwest than it was in Korea. The breakdown of the dollar and so forth and so on. But noted it comes back to none unionized, none structured labor pools which can continue to be exploited. Now what the data implied relative to the new immigration act which is enforced in 88, means there's isn't going to be enough hope to pick your cabbages and your melons and so forth, but your 086 and your psychotic 086. Things work together. The institutional framework from which real estate operates is extremely 088 and extremely broad. The third scenario, of course, if your a pessimist is we actually have atomic destruction, that we might have significant default on foreign and domestic loans. That never will get our government deficit under control. And that we eventually will have to have drafted deficit control and a real austerity program. Period of rising unemployment concentrated particularly in the traditional areas of defense manufacturing. Obviously spreading ultimately to other industries as well. Real interest rates will have to remain high for most of the 1980's, but one deflects inflation and two protect us against a run on the dollar by overseas money. We will have social destruction in our cities where we have 25% of our population now in poverty. The number and percentage of ratio and absolute number of poverty has risen under the Reagan administration rather than decline. And they're getting less. Question is can we keep them drugged long enough so they don't fight, its a real question. Which of those social scenarios, economic scenarios do you want to take? We should begin to influence then your view of real estate--and real estate investment versus development. Exploitation of the opportunity of the short term Keysian active investor, or whether in fact as a portfolio investor you have to be fatalistic and say gee, I need the diversification because I don't where lightning is going to hit next. So they all can't fall down at the same time. But what with you read the systematic where the stock investor likes to talk about. Beginning the task 113 much more significance than the nonsystematic risks which can be relatively easily stabilized in real estate. And so we begin real estate investment by having to make a fairly mushy set of assumptions about the future context in which one operates. Keeping one eye to the leeward as it were and having a hope about the future, or otherwise you're going to the seas and drudgeries and the mason jars in the back yard. Think about that. What is the hope, what's the framework within which we're now going to build a rationalized systematic method of selection and management and presumably increase of our net worth. If we look at the rationalized nonpsychic income benefits of real estate its only two things--one, increase our spendable income or two, increase the net worth that we can benefit from in our life time and pass on to the next generation. The most significant thing Reagan has done is to allow the middle class to pass on their net worth by raising the exemptions significantly on the federal estate tax so that it can pay us more or less in tax with the minimum liquidity exposure for the next generation. We'll begin to look at that as the semester progresses. How do we improve/group 133 our spendable cash, how do we improve the liquidating value of our net worth so we can transfer in this life or the next to whatever cause or purpose we wish. Okay, we'll come back to that next time. (end of tape)

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Sorry for the delay, just as I was coming in I got a call from a Pension Age and I had to give them a report on higher education and 856 in 15 minutes. Can you imagine what that's going to look like? We started out with, which numbers do you think is the right number in appraisal? As a result it took 20 minutes. But he now knows which number is the right number in appraisal--my number is the right answer. Okay, I understand your readings are now ready at Bob's Copy Shop. You can take a pickup truck now and bring those home and that should keep you off the street until the better part of the week anyway.

We were talking at the close of the last session that there's a certain irony to the real estate investment process because, while we spend a great deal of time in systematic analysis and two point decimal measurement of returns and ratios of one form or another, it begins with a rather soft hope about the future context for that investment and those hopes really can be subdivided further into a hierarchy of concerns and I would like to begin to define those, recognizing as there is not absolutism unfortunately in real estate other than insolvency and Chapter 11, which is relatively absolute and final. I came back from Texas where that seems to be a chronic problem. Even the late great Vice President, Connelly is going

through bankruptcy as a result of his real estate holdings and was pictured prominently in the Dallas paper on Friday morning, selling off the family heirlooms to contribute to the liquidity of his enterprises or nonliquidity as the case may be. At any rate, Texas is a disaster zone, but a very great opportunity area for folks that would like to learn how to run real estate under difficult conditions. And I mean that quite seriously. While I was there, there was one bank I worked for, First Republic, and I think during the day we created at least six new positions in real estate appraisal and asset management in which you can really get some super intense responsibility with hands on management of assets not even mentioning of course what you could do with FSLDIC and so forth. So if you really want some big toys to play with as a postgraduate education, defunct real estate all over the country offers some wonderful opportunities.

The hierarchy of that we'll talk about is first political exposure. I'll expand on the details of it, I'll just give you the seven initially. The degree of market monopoly. Three, the degree of management enhanciveness. Four, the financial attributes of the enterprise, and I guess if you're being precise you can say economic/financial attributes of the enterprise. For example, a hotel is a fixed expense variable revenue type of enterprise. As

compared to a triple net lease back to a AAA credit which essentially is in the nature of a bond secured by real estate. Number five, the number of decision points which allow one to make an abrupt exit. An alternative way of looking at that is the length of the commitments. Number six, would be the federal and state income tax attributes. Even tax exempt nonprofits are sometimes taxable and not exempt. And the last one, number seven, is the fit of the real estate to the estate for distribution plan. We typically look at estate plans as something peculiar to an individual looking at who his heirs may be and so forth, but ultimately any corporate enterprise has a distribution plan. Sometimes it's explicit to finite real estate investment trust says whoever still owns a share of our stock in tenth year will participate in the liquidation proceeds of the trust. The closed end fund for the pension fund says probably between the tenth and twelfth year we're going to terminate and sell off our properties and distribute the profits presumably from the property. Well, that essentially is an estate plan only for a corporate body as opposed to a physical body and quite often that estate plan is a significant ploy in the total investment. Certainly even more so prior to the 1986 tax plan in which if you went into a 30 day liquidation there were no capital gains taxes paid by the corporation, the double tax attribute dropped

out and the proceeds moved right through to the tax payer and the tax payer sorted out what was open on the property and so forth. Well, that may be part of the ploy--how do I get out of this baby and how do I move through it? Or maybe I want to structure my real estate so my distribution plan really is ultimately a spin-off of assets created from the real estate side to shareholders or perhaps I want to roll it up in corporate merger into a larger corporation. Many times that's done of course, simply claiming it as it appears in the short term but many many times that's part of the long term plan of the investment. Well, it's not only as important to figure out how do I get into it and what do I do with it when I got it, its also important to figure out up front how do I plan to get out of it. Because there may be investments that you can't get out of and that you would like to get out of. For example, in structuring a deal with Dave Schuler, some of you've had it at deal on a land lease, in effect, what we did was, set it up so that at the termination of the land lease the owner of the land can reject accepting the property back. That if the building hasn't been removed from the site at the option of the owner of the land, he, in fact, gives the deed to the building owner. Why would he want to do something like that? Well, specifically because in the event of a seismic disturbance on the West Coast and the building half falls down and you

are now notified by public authorities to remove it because it's a hazard to society, that's a hell of an expense and you don't want to do that. You want a way to escape that and so you can say, "Fine, tender the building to me and I'll tender you the deed and you tear the building down, it was your building in the first place but I wanted a cleared site." And since you won't give a clear site, you got the deed baby it's yours. And so you really ought to know all of the practical ways in which you're going to get out as well as the way you're going to get in. Put the light in at the end of the tunnel so to speak. You never want to go into a tunnel in which it's all dark at the other end, because you never quite know when that locomotives going to be coming through from the other way. So build the light in at the end of the tunnel as part of the plan. So now let's look at those seven items in detail.

All of these are relatively soft issues obviously reflecting the component of hope, a direction in which you are hoping to move the enterprise realizing that as we refine the time period more and more will be on a program of improvisation--improvisation guided by these general longer terms' objectives. If we take a really long term view of life, maybe our hopes will be realized with a great deal of bumps along the way. On a day-to-day basis it a little more problematic and messy. I think most real estate investors

today, particularly institutional investors today, realize that their primary risk is a political exposure. And that political exposure takes three forms--one of course, is changing public land use control patterns. When I bought it, it was conforming, they changed the rules, now if I stumbled to nonconforming use they won't let me rebuild it or the next buyer won't be able to develop it as I thought he might or whatever. There's just an infinite variety of little surprises and upsets and therefore you notice developers spend a lot of time talking about when do I have a vested interest in the property, zoning, and so forth. I've come in, I've done my plan, I've got the plat filed, and so forth, when does it test, when does it say I can do that without having someone come in and say, "OOPS, wait a minute, we've changed our environmental rules--the traffic congestion is too high, or the population density is too high or, as in California at one point, golly gee, that's a beautiful development you've got there but unfortunately now its important that the public driving by on the highway be able to see the ocean from all points and therefore, you can't build a house that goes more than two feet above the grade. OOPS wait a minute, I'm on to something there, what happened there?" So public land use control laws represent a significant risk but perhaps not as critical and damaging as the next two.

One, political subsidy to the competition. After all the price that you can provide in real estate and your ability to compete really is a function of your cost of capital. If one guy gets capital for 4% and the other guy gets capital at 10% and they build the same one, the same features, whose gotta have the lower cash flow, therefore the lower prices to survive? For example, Anchorage, Alaska--the Westward was built prior to 1964 with a conventional mortgage. Along came the earthquake and Mr. Hickles lost his little teeny tiny hotel and immediately got catastrophe financing from the SBA and I think it was a magnificent 4%--so he built a great big hotel and called it Captain Hook. The Captain Hook pretty well put the Westward on the ropes and after all you can build a really nice hotel at 4% interest and the poor guy's that laboring under a 10% interest has got himself a problem, right? But then along came the federal government and settled the natives on the land, ten year act and in addition to giving him forty million acres of land, also gave him about 1.6 billion dollars in cash and one of the native tribes says, "Gee, we ought to create enterprises in which we can hire our own natives, so I think we'll build a Sheraton Hotel--cost of capital zero." No mortgage, all equity, they built the Taj Mahal, you know, glorious. The Captain Hook is now for sale and on the financial troubles and nobody ever heard of the

Westward again. A major risk is the subsidy of your competition. That's really what the convention center fight in Madison is all about. The Concourse built its own hotel with conventional financing. Jerry Mullins build his own hotel with conventional financing. And suddenly a couple of idiots on the City Council come along and say we need a third motel. One, we don't like Darrel Wild, Mullin's hotel is kinda old and tacky and it doesn't have any sense of style, so we want something that will really put Madison on the map. So as a result we're going to pour in City money and we'll build them all of their public facilities, we'll build them a parking ramp, we'll buy them the land to do it, presumably rent them the site at a reasonable price. We'll create a TIF and underwrite some more of their costs and all you got to do is build the bedrooms, wonderful. Any idiot can make a hotel work if all he's gotta do is build the bedrooms. Bedrooms don't cost that much to build and if you're renting the bedroom at \$70 a night, and you do that 20 nights out of the year, you're getting \$1,400 a month for something less than a one bedroom apartment. It's pretty hard to fail on that basis. Well, there are guys that do it every day. It's pretty hard to do though. And suddenly Darrel Wild says, "Hey, what are you guys doing to me? I'm barely above water now and I've modernized my hotel, you know I didn't ask for any favors." Mullins has really

become the fair haired boy of Chris Talinser and Mr. Lufler, couldn't he be getting permission to make a right turn off the Square. They're trying to get to the parking ramp, the public parking ramp from the front of the Inn on the Park, you gotta make a left turn go down to the former Penney's building, make a right turn, go all the way down to Wilson Street, make another right turn, come all the way back up the back side to get to the County ramp, it's insanity. You gotta go nine blocks, literally nine blocks, to get to a parking ramp which is out the back door of the Park Motor Inn. Why? Because the City says, "Well you can't make a right turn because we promised the federal government that we were going to make this a bus mall and if we do that we might have to give some money back to the federal government and suddenly you're bothering them anyway, because they just blew \$592,000 on UDAG grant on the Manchester Building, but that's another problem." Total incompetence. Notice two hotels both of whom have made private capital investments, without any help, cooperation or even a kind word from the City, suddenly find they're going to have to do battle with a third hotel. Wild's idea is good, let's kill the damn convention center if its not going to be attached to my hotel, which is perfectly legitimate, and Jerry Mullins attitude is wonderful, if they're going to build a third hotel, by God its going to be my hotel so I can shift the

business back down on the Inn on the Park and screw the Concourse. Both of them trying to correct for something they just really want to do which is have a third hotel. Now we do that all the time. Sometimes legitimately. We say, "Gee we need elderly housing and so we'll build special units for the elderly where they only have to take 25 or 30% of their disposable income"--and they move out of wherever they were because you can hardly beat the price and depending on, of course, how loosely or laxly the eligibility rules are determined, suddenly the apartment owner who paid for his own unit and has to pay the full blown cost is competing with somebody down the street who is heavily subsidized. But the flip side is just as bad. What if your own demand is significantly subsidized? What if you own a real estate investment project in a small town which is largely dependent on the dairy industry and the revenues and the retail expenditures in that town are a direct function of the milk parity price. Or the military base just down the road, or some other government program. The miracle of the Northeast or New England isn't such a miracle because when you figure out that Massachusetts is getting more dollars of defense budget per capita than any other state in the United States, by a significant margin--that's supporting their real estate boom. That's supporting their office rents, and that's supporting their home prices,

that's supporting their retail sales and their shopping center prices and so forth. Once you get on to that, how do you get off of that? What if the next President really said hey gee we've got a lot of other problems besides defense expenditures, and so we're going to cut back and we're not going to create all these windbanks super duper defense things--where are they going to be in New England then? For that matter, where are they going to be in Texas then? Notice your real estate prices are extremely sensitive to political process. Land use controls are the obvious ones, but the less obvious ones will kill you. The degree to which government programs, which on their face are not necessarily bad, subsidize your competition, undermine your profit. Maybe Bob Linton has a good point--I built the Tenney Building and remodeled the Tenney Building myself and now you guys are pouring UDAG money into the Manchester Building to kill me. And Darrell Wild who hasn't had any help at all on the James Wilson Plaza is watching his tenants being bought out of his project by UDAG money that was given to the Manchester Building. Hey, either you gotta learn how to play the political game real well, or you have to begin to look at the political exposure of your product. Because most of your hopes could end in that process.

One of the questions asked me by First Republic; during the day I spent most of the day with the appraisal section

and the bank's investment objectives are under the gun. Some of them, of course, made bad mistakes in the energy area, I guess it was, and Republic Bank made mistakes in the real estate area and so they held out 1,600 properties presently not doing necessarily very well or anything at all and as a result they have appraisers to attempt to reappraise each of the properties each year. And even when they bring in the independent appraiser when they start to look at them those property values are coming down. I was in a bank building in Little Rock, Arkansas, and last year when it was appraised in January at \$42 million, this year it was \$34 million. Unfortunately, that's going in the wrong direction relative to the mortgage which is accruing interest at the moment which is going the other way. Very very sensitive obviously to the appraised value as to whether the bank system is essentially solvent or not. But in any event, in the afternoon I met then with the loan officers, as well as the appraisers and the loan officers are hot to make loans because that's where you get revenue for the bank. So you have this interesting battle between them that wants to produce current income and therefore hold it in for the lending staff and those that are trying to define net worth in order to keep the banks open. And they wanted to invest in Austin. And one of the questions posed was, well don't you think Austin will continue to rebound

because our lower costs in Austin will continue to attract people like Semitec, Semitec as you recall was the one that might have come to Madison, they didn't, they went to Austin. And I answered them and I said don't kid yourself, people didn't come to Austin because of your lower costs. People came to Austin because you people are politically more astute than your competition. I'm willing to bet that most of the people would rather live in Madison, Wisconsin, if you ask the staff because our summers are cooler, and while our winters may not be all to write home about, if you like cross country skiing, we're certainly the place to be. I said your real advantage was the fact that your Universities get and your University's is a tool of the state. And when Semitec came down and said gee we would like to have the following kinds of endowed chairs in cybernetics, the university was perfectly willing to do that for them. And we need to have soft money so that we can afford to buy homes with our employees, the State Housing Finance Authority stepped up and provided the soft money. And we need a plant immediately, and they said, funny you should mention that, Control Data has this little number over here that's vacant and ready to go and we'd only be too happy to convert it for you and for about \$16 million we come up with a clean room and a bunch of other stuff that you wanted, but chicken feed, you're in Texas and so on.

And they put together with the State, the University and the City of Austin all working together for the \$65 million package that was pretty hard to beat. But Major Sensenbrenner came up with, we'll make it a TIF district. We'll spend \$22 million of general obligation bonds on a convention center but we wouldn't step up and put \$10 million into Semitec. Insanity, absolute insanity. In the meantime, it's not quite clear whether the State and the University we're really talking very well together at all. You can talk to Jim Carley, he's kind of fed up with the University--that thinks we are above being used for Semitec. But to the degree that there's something in it for us, the University, maybe we'll play ball. That's not the way they do it in Texas. Everything is for Texas. The University is for Texas, the State is for Texas, Austin's for Texas. And if for some reason they decided they liked San Antonio better than Austin, Austin would have jumped right in and supported San Antonio location. The real asset they have is political savvy and they got the right chairman and the right committees in Congress. That's their answer, that's why Austin is a good place to invest. Even though right now it's a disaster zone, an absolute disaster zone. The vacancies in office space and apartment buildings have never been higher. The quality of apartment buildings has never been lower. But you don't want to bet against that

political environment. The first thing you need to have is not economic base, you have to have political base. Political base has to be sympathetic with private investors. Therefore, you want to look at the land control use mechanisms obviously, you also want to look at the willingness of the politicians to either subsidize demand or subsidize competitive supply. To the degree that they will subsidize demand is a good thing. To the degree that they want to subsidize supply you're in real trouble. Why anybody would want to invest in downtown Madison, where the City Council just doesn't understand the difference. I don't know.

The second element obviously, is that the drive wheel once you get beyond that political process is market revenue customer. The object of enterprise is create a customer, anything you do after that is redundant. There are four ways to create customers in real estate. One is direct control of the ultimate customer. That is the best of all possible worlds. Being the President of the bank I can decide where the bank is going to lease, then I choose to take lease of my building. Short of that is the grand old American tradition of reciprocity. I own the bank, I'm going to own the building, but I think it's important that my accountant, my attorney, and my investment banking connection all be in my building so that we can talk

conveniently by just running up and down the elevator. Surprise, surprise, Arthur Anderson, Robert Bard Company, and so forth, they're all in the First Wisconsin Building in Milwaukee. (The Name of some Milwaukee Law Firm) has three floors, some of their partners left because they didn't want to go and pay that kind of price per square foot and have it come off the bottom line when it came time to divide up shares and bonuses among the partners. On the other hand if they wanted to continue to be dominant in the legal work with the bank, one could understand the convenience of being in the same building. Much American real estate is done through reciprocity. Whether you lock them in directly or indirectly isn't so relevant; it's the fact that you do in fact have a lock in on your tenant mix. Now you raise your hand and say, "Gee tie-in contracts are illegal under the Constitution." That's true, but you don't state it as tie-in contract. You just let it be known by body language that it would be a desirable thing for them to do. You build relationships in the U.S. business scene. Relationships is another way of saying that there will be some degree of reciprocity.

The third element of course, of market control comes through what we will call channeled demand. Channeling because of the terrain, there is only one direction you can go, you gotta go this way, everything else is too wet. For

example, that's San Francisco. San Francisco is a very tight little island with little connection to the main land going South and as a result, very tight supply, relative to the population density. A fortune was made in Southern California in the early days of the California drought by a number of friends such as Property Research, Inc., which simply mapped each increment of public infrastructure in the direction it was going on the five year capital budget. Where would the interchanges be built, where were the interstates going to be built, when was it scheduled to be built, when were the funds appropriated, and then just follow that out. And you could go to Property Research as a professional athlete and say, "Gee, I've got five more years of high income as a basketball player and then I'm on my own and they would say great, we'll buy these little orchards right along here, by our scheduling in four and a half years they will be on an interchange and ready for residential and commercial development and so forth, and son of a gun it worked beautifully." They got five years of tax deductions carrying the property forward rather than just simply holding and puff, it blossomed into a magnificent capital gain more or less on schedule. Channeled demand. Obviously channeled resulted in utilities infrastructure, linkages. I like the term channeled demand rather than monopoly because a number of years ago in a case I was representing the First

Wisconsin, they were accused of monopolizing the downtown office market in Milwaukee and I worked for a couple of antitrust attorneys that were defending them and they were appalled to hear me say free enterprise is the art of creating your own monopoly if only for a moment. That would have been enough to drop them into oblivion. If I had to find a new term for our theory and now we talk about channeled demand.

Failing the first three--direct control, reciprocity or some natural channeling of demand, we fall back on the least desirable and acceptable method called market research. Identify a gap in the market that is not served well by the existing product. Identify folks who are unsatisfied, folks who have needs that are unmet. Actually go out there and meet a consumer. Pretty radical stuff in real estate investment. Not that many people bother to do it, some people give lip service to it, but it's certainly a major source of market control if you wish to use it. But notice you need to be able to operate in a monopolistic situation. There is chronic oversupply of virtually everything in real estate, therefore you need customer control. Never never compete on price. Question--can you give an example of what direct control means. Chief--Sure, Affiliated University Physicians, Inc., represents the 250 doctors that practice medicine at the University's Medical School and Hospital.

Okay? They have to have a major administrative facility. They have a contract with the state which says that they take their total billings as doctors, they subtract their operating expenses, etc., and then they divvy up the remainder between the state and the doctors. So far, so good? One of their expenses is rent. They used to be in somebody else's rental building so they said to the State, "Do you care where we rent?" And the State said no, as long as you don't pay more than market rent. So they built their own office building. They've got 18,000 ft. out here on the Westside. They rent it from themselves. The doctors have a partnership called Synapse Associates, which represents those doctors that practice medicine at the hospital if they care to join. They pay rent which pays off the mortgage and gives them cash dividends as well. Tough to lose on that kind of proposition. Captive market. Okay? Direct control of the client. Lots of deals like that. If I'm the President of the XYZ corporation, I probably own the office building in my own name and rent from me. In the days of high depreciation, that was one way of sheltering my effective income for one thing, besides that I'm taking money out the back door of the corporation as a rental payment which is a single back payment rather than a dividend which would be a double back payment. And if I do that correctly and I have a few pension plans and so forth

as well, pretty soon there aren't any taxable income in the corporation either. You see? Lots of goodies of that sort. If you think insider trading is unique to the stock market, you are going to be very surprised. The insider market is the market in real estate. Knowing something about the entity and play of tax. In real estate it's permissible and it not regarded as unethical, in the stock market that's something else.

Management intensiveness is the third attribute. Obviously, the high degree of instability of any enterprise is attributable to the mortality, the morbidity and the instability of the individuals who run it. The more mechanical, the more robotic the management can be, the more fungible the management can be, you can take any MBA and stick him in the spot and he can do it--wonderful. One way to make that automatic, of course, is a triple net lease back in which the tenant is responsible for all of the project management. Which, by the way, is in the AUB assigned lease in your case study. AUB is responsible for everything, including your share of the building. The rents, by the way, is indexed to the CPI, so as a result you have essentially an index bond set up for the investors in the profit. But, of course, with less risk, less return. One of the real problems with anything that is really robotic and really virtually an automatic increase/step-up

is that there's a great deal of competition for those and the yield gets very finely defined and til pretty soon it's a couple of basis points over the interest rate, etc., and the upside is relatively minimal. We can begin to move up from that triple net lease to providing perhaps a little more flexibility for the tenant. Instead of having him locked in for 25 years, he's locked in for three years. From the tenants' standpoint, maybe that he's willing to pay a premium for, and as a result you get a little more income and so on. Each time we add additional dependency on entrepreneurial foresight and ability, the return potential of the upside goes up but so does the return on the downside. Most real estate in the nation today has been moving toward some way of making it a no brainer as far as the investor is concerned. Classic example. Mountain Jacks--before it was Mountain Jacks it was the Boar's Head or something of that sort. Well, the Boar's Head, first of all was owned by Purina and Purina had a number of cattle feed operations that tested their feed which left them with cattle which then became steaks which then they needed to have a market and obviously if they could get the retail price of the steak they were going to do better than the wholesale price of the steak, so they started a real estate enterprise. So far so good? The problem with restaurants today, is that they are very unstable, generally cooks are

very unstable. Not to mention the waiters and waitresses and the rest of the crew. So they industrialized the whole process. They said first of all we don't want a cook. We'll take any idiot at the age of 18 that we can teach how to cook steaks in about three days flat and the way to do that is simply cut the steaks various thicknesses, so that if you want it rarer you use a thick steak, which is a little smaller in circumference than a medium steak which is again a little smaller in circumference and thicker than a well done steak which is smaller in circumference and thicker and as a result all steaks take the same amount of time. And then we'll buy Sara Lee and we will freeze absolutely everything else that we need to do so that the kids out of high school can thaw. We'll totally industrialize the kitchen and if he walks out of here tonight, that's wonderful, I have a 16 year old that can come in the next night and do equally as well under the supervision of an MBA in business who studied management and wouldn't know how to boil water. Now on the front end we're going to create ambiance and so we're going to stick the waiters and waitresses in little colonial outfit and the real estate investment is the core so we create the romance and we'll create a gas log fireplace for the den, we want to industrialize the fire. It's just a lot easier when you come into the work in the afternoon at 4:30 you turn on the

gas jet. Presto, we can now sell you romance of the old colonial ambiance and we can produce a very high quality dinner continually with totally unskilled help. Our big problem is going to be teaching our waiters and waitresses the difference between a butter knife and a steak knife and on which side of the plate it's supposed to go. And how to serve the soup with a ladle without actually spilling it on the client. We can crank those babies out and just go with it. We have removed the management intensiveness that characterized, let's say, a real gourmet restaurant in which the cook really had to have spent 10 years in France in which the maitre d' is really concerned about the food and so forth and so on, but he's a highly unstable individual with a tendency toward alcoholism and what else and we never know whether he's going to show up for work or not. Real estate is moving towards that kind of industrialism. If we can continue to just to spit out industrial buildings on triple net leases in which the total management required is that we have one guy in town that can change light bulbs and put patches on the roof leaks and so forth and so on, pretty soon we have a fairly viable management enterprise.

Management intensiveness. The more management intensiveness, the more we are dependent upon a single personality, the more we are dependent upon a high skill level to operate, the more of our returns go to management

and the fewer of our returns go to real estate. One of the reasons pension funds have been reluctant to invest in apartment buildings is they regard apartment buildings as intensively managed real estate. And it's true, they are intensively managed. It requires a great deal skill and art to run a good apartment project. It's a skill which they have not yet discovered in Texas. I was out with John Peterson the other night, he was looking at projects in Texas, he was absolutely appalled that they could even build them that way. Projects that are three years old look worse than some of ours in Madison that are 50 years old. They get some guy who came over the border over night, painting it with a broom, and the carpenters he has well, he probably has one on the job trying to coach the other, but somehow they never did master the idea of joists that are 16 inches off center, they are of various dimensions and the floors kind of go up hill and down hill with the joist and so forth. They could make great investment products. The limited partners really bought them up because they were really great depreciation opportunity. They didn't know how fast they were going to depreciate. Accelerated depreciation underestimated the rate of decline. Okay, in addition to being sensitive to the personalities involved, management intensive properties are also very sensitive to time. Time delay. And apartment projects in Madison if it

doesn't rent by the time the semester begins, adjust themselves through price.

Okay. The next set of attributes would be the financial attributes of the project. Notice how far down the chain they really are. Until we have some sense of the stability of our political environment, and we have some sense of the degree of monopoly that we enjoy in order to stabilize our pricing system, and we have some sense of the managerial sensitivity of our project, its obviously going to control our costs and the reliability of our proforma expense estimates, we really don't know anything more about the financial characteristics of the property. Once we get into financial characteristics, the first thing we really need to know is what profit centers are appropriate to this investor? What profit centers are appropriate to a particular investor? A real estate investment trust by law must remain passive in the operations of its property. If it's going to remodel, it's going to hire it done by an outside developer. The profit center goes to the outside developers. If it's going to lease, it's going pay leasing commissions to somebody else. Anything that looks like an entrepreneurial service that might be appropriate to that real estate must be done outside the REIT because it is defined as a passive investment vehicle. Therefore, some of the profit centers that make real estate attractive are

simply not available to an REIT. If we're looking at a project which is still conceptual, then presumably the investor in control might make a profit on the land, another one on the planning and engineering services, another one on the construction and development, another one on leasing commission and ultimately property management, and financing, etc., etc. We need to know which profit centers, we as an investment enterprise are capable of retaining and which ones are best farmed out either because we don't have the expertise or because the risk is so great that we just as soon have somebody else take the pounding. Relative to that, we need to know

the time line along which those profit centers occur. Assuming a project has a 120 month cycle, 10 years as it were, what profit centers are available in the first six months, which profit centers are available within 12 months, which profit centers are available within 5 years or 60 months? And therefore, what is our investment strategy hoping to control and capture for the benefit of the investor. Once we have some sense of the profit centers as they may be, which ones we think we can garner and where they fall along the time line. We can then begin to look at some of the financial characteristics of the property. Obviously there's going to be a reliability of revenue estimate. A reliability of expense estimate. And, a risk management device which allows us to control the variances in both revenues and expenses. That control of variance can take a variety of forms. We're all aware of leases, which have pass throughs from the landlord to the tenant. Financing structures which are non-recourse so that if the project fails you can hand it back to the lender without further liability. Master leases which guarantee us a minimum revenue line--all of those kinds of things that we talked about in 551. But each business, each enterprise, each real estate project can be characterized in terms of the customary or traditional control of variance that is available for those who are astute and good negotiators and

good business people. One of those critical financial risk measures is the cash break even point. Perhaps the critical ratio is the cash break even point. If we're talking about an FHA project in which the tenants receive substantial subsidies, the cash break-even point is always 91 or 92% of the gross rents as set by FHA and the rent control program. On the other had, if we're talking about a resort hotel it may be necessary to put our break-even point down around 50 or 55% of the potential gross in order that we can survive the early years of building, a clientele and establishing market reputation and somehow acquiring our share of the market. We need to look at that relationship of the break-even point as one of the most telling ways of characterizing the property. The other critical element of course, is the degree to which we are a fixed cost variable revenue enterprise. The more you are a fixed cost variable revenue enterprise the more critical it is that you create a monopoly for your real estate. That's true of industry around the world, not simply real estate. Those industries which are most capital intensive are the one's that have developed the most sophisticated systems of price fixing and stabilization of their own. Farming is good example of an industry which has its troubles doing that. The price of milk tends to wiggle, the cost of feeding cows does not. Cost variable revenue enterprise.

Once we have all of that, then we begin to develop simultaneously measures of risk and measures of return on the property. And I think you'll see that the center and the nature of the real estate enterprise is that which is an appropriate measure of risk, and that which is appropriate measures of return will change. If we're talking about a land development company like Gulf down in Florida and so forth, we may be really looking at ratios such as the inventory turnover or the rate of runoff on land contracts receivable, or other factors such as that that really measures the revenue risk or the cost risk of the enterprise. Then again if we're looking at a mobile home manufacturer and subdivider, we may be looking at the number of times they turn their working capital per year. Or looking at the collection lag between the delivery dates and the collection on their mobile home to their dealers or whatever, we'll certainly develop different measures of risk that try to get at the critical fulcrum, the critical dichotomy between success and failure for that particular kind of real estate. And it may have to do with occupancy rates at a hotel, it may have to do with break-even cash, break-even ratios on a hotel, excuse me on an apartment building, lots of different ratios are revealing of the balancing point that exists between success and failure. Next I expect to look at the decision point. Decisions must

really depend on two elements, one how long is the time line that we were talking about. Developers that were doing Section 8 apartment buildings a couple of years ago really were looking at about an 18 month time line, from the time they were in to the time they were out of the development, at least out in terms of any cash dollars of their own. They probably had some costs for six months while they negotiated with FHA and WHEDA and so forth for their subsidy and their insured FHA loan guarantee and so forth, they probably had nine months to build the project actually, they had three months in which to finish their audited costs and get it rented up and so forth. They then close on the loan, closed on their partnership proceeds and they were home free and they still had a residual interest in the project with a management contract, etc. Eighteen months was the time line for that and, therefore, the decision point is to whether we had to do that again, was relatively short. If we're doing a shopping center the time line, from the time we initially started on the site, until we get all of our stores in on leases and they're actually paying dollar rent, is probably five-to-seven years. And once you start moving down that time line there aren't very many ways out. Once you spend money on planning and environmental reports and feasibility studies and market studies and leasing and so forth, by the time you get to the third year you take a real bath if you

were to sell the site to somebody else. Because the land as land is worth one thing, the investment that you've made in all of those soft costs are subcosts which are not recoverable and unless you see it through to the bitter end and it gets the entitlements that you're going for, and you get the leases that create value to the site and so forth, there's no way out. There's a wonderful line about the drunk coming out of a saloon on State Street, running into a street light, feeling his way all the way around the street light post and sitting down on the pavement saying, "I gotta give up there's no way out." Many real estate projects are of that kind. Short of bankruptcy or suicide there's no way out. A limited partnership is a classic example of having a very limited way out. You can't sell it to people because that would give it marketability. The land that the general partner doesn't want to buy, you're in trouble there, etc., etc. And my friend, Bob Rogers says all you can really do is give it to your wife for Christmas and get a divorce by June and you're out. Decision point--how many points do I have not had an opportunity to reconsider. Can I structure the deal so that I can nibble my way in and nibble my way out at a minimum sunk cost at any point along the way. No wonder developers are so chincy and try to get architects on contingency fees that say draw me some pretty pictures now and if the project goes, I'll make you a five percent

partner. And the architect says, "Gee that's really nice nobody ever made an offer that way and he never sees dollar one having spent hours and hours on the drawing board and so forth." And he goes to the property owner and says, "You know your land as corn fields is only worth \$1,000 maybe \$1,500 an acre, but if we can get shopping center permits for this, its worth \$5,000 an acre, you'll just have to ride with me for about a year and a half." So he gives away an option on his land in which if it goes he gets \$5,000 an acres, if it doesn't go, he gets nothing but the option to paste on the wall and a dollar for due consideration.

Obviously, everybody is looking for ways that they can bale out and have a minimum sunk cost along the way. Sometimes we call those options, sometimes we call them contingent purchase prices, sometimes we deliberately create a nonrecourse land contract so that we can take a walk on the project if it doesn't work. So we try to build decision points along the way which allow us out at a minimum cost. Sometimes we structure financial hedges to do that, so as the market changes in one direction we profit in another.

A classic of course, through the investment process is procrastination. Skillful procrastination in a real estate development deal is critical. And it takes many forms, for example--our client has a shopping center down in Phoenix and one of the clinkers in the shopping center, which we

knew when we bought it and we really looked at it as an opportunity, is that Woolworth had a two unit department store on the site which they subleased to one of these home products groups, which provide lumber and mill work and all forms of hardware for the homeowner and they marked it up considerably. Let's say that the base rent calls for \$1.60 sq. ft., the market on the space is \$5.50 presently and they're not sharing it with us as the holders of the shopping center. So we're proceeding on one front to sue them on the grounds that it violates their participation percentage lease and on the other side we're proceeding to try to negotiate with them to buy it. Well, Woolworth moves along at a rather glacial pace and one's never sure from one moment to moment whether they know what they're doing or they don't know what they're doing--the position they're taking. Well, finally we're given up on the whole thing, we've realized it was special situation when we went in, we've enhanced the whole center, cap rates have fallen in Phoenix and now's a good time to bail out, take our profit and run. Well, we have an offer on the table now and the guy comes in and says, "Gee, I need 120 days to do my due diligence. Wait a minute, hold on, wants 120 days to due diligence. He's another shopping center developer in the area and for one thing he would love to look at the leases and find out what the termination dates are of the other 80

tenants in the center, that would be a useful thing to know in terms of your procedure and second of all, he obviously sees the same thing we did. "Gee, if we could just get Woolworth out of there, this baby would really fly." Its no trick to come up with something you don't like about it and say, gee, my board rejected it because there is a crack in the left rear wall which suggests that they are directly over one of the major faults on the West Coast, or California will remain and the rest of the U.S. will fall into the sea and take your center with it. Okay? Now, notice what they're doing is building into their deal decision points so they can say, "Gee, we went and locked horns with Woolworth and that's not going to work out, so I don't think we want it." Then they're setting up, you know, they're saying, "Gee, if you close with McDonald's on that pad that's circling, that clouds the opportunity for us, because it reduces the parking ratio, etc. They're already setting up their escape point. So at that point you say, "Wait a minute, hold everything, that's not really a firm offer." So you say, "All right, tell you what we're going to do. For \$100,000 we'll give you the option and we'll warrant everything in the Center is as we tell you it is. And give you 60 days to fish or cut bait, but if you don't cut bait, we keep the option money. All right?" Notice at that point all we're doing is saying, "Great if you don't

have any luck with Woolworth that's fine with us, but we get to keep the \$100,000 and they have to pay \$100,000 to find out whether they want to go do battle with Woolworth."

Since its worth a couple of million bucks to get Woolworth out of there because of the capitalized value of the rent differential or the lease hold interest, as it were, of Woolworth, they have to decide now, gee, do we want to throw \$100,000 on the pot to decide whether we can negotiate better with Woolworth than they can. Now they may have an inside deal. They may know the Chairman of the Board of Woolworth and he'll tell their attorney these are nice guys and they're friends of mine and what's more Woolworth needs to book \$2 million of earnings in the Southwest district this year, etc., and so we'll sell. Maybe possible for them to do that, when in fact we didn't succeed in that.

Nevertheless, classic case of figuring out where is the decision point, are they procrastinating, are they drafting that offer to purchase or that offer to sell in such a way that they really have another kick at the cat? Until something else becomes more clear, or other opportunities become more relevant--decision points. When do we have to make a decision? In any real estate deal in which you can retain control and at the same time not make up your mind right away, it's a good deal, that's why people rent with option to buy. Of course, sell with the condition that, you

know, the Board of Directors has to approve it--the old ploy. Gee, Harry I thought we had a deal but the Corporate Board said no. Of course if you had been at the corporate meeting you would be hearing this guy pitch an entirely different message to the corporate board saying, "Let's get out of this one guys I've got a better offer coming down out of the pike", and so forth, and so the Board would turn up their nose and say, they didn't feel the prospective buyer was credit worthy and they couldn't agree to such and such a term, and therefore, they were rejecting the offer and in the meantime you have the 90 day option on the property. Decision point.

The last two we will talk about in more detail obviously ad nauseam a little later in the semester. The federal tax and income saving effect _____ and the so called estate accumulation and distribution plan for individuals and business entities and we will pick up on those the next time around.

Obviously the federal and state tax laws in some ways are working together and in some ways work counter point to each other, and you really need a short term and long term viewpoint. The short term view point is obviously is to minimize the tax by hopefully postponing it, possibly avoiding it. But, the long term viewpoint really has to consider the consequences of that. For example, all of you

I'm sure are familiar with the concept of the cross over point. The cross over point is that point where the tax depreciation is no longer sufficient to cover the principal payment due on the mortgage. Nobody wants to, obviously, pay on principal with after tax dollars because if your tax is 28% you obviously have to earn somewhere in the neighborhood of \$1.30 or a little more in order to have a dollar left to make your principle payment. It obviously 20 would be much more desirable to make payments on the principal with dollars that have been sheltered by the depreciation.

Most of you are also probably aware that traditionally the depreciation payment is declining with time, partly because of the nature of the format that you've taken, partly because of the fact that different assets within the enterprise have different useful lives and are on 10, 5, 3 and 28 year life and, as a result, you would have written off various components of your total investment your total depreciation component starts to decline. While at the same time the principal payment of the loan is obviously starting to rise by the very nature of fixed interest payment mortgages, is sometimes, for that matter, a highly structured mortgage. The interest payment gradually declines and the principle portion gradually increases and so obviously you have a curve as far as the principle

dollars are concerned, generally rising with time, at the same time that the curve of depreciation is declining, either in a smooth fashion or in a step down fashion as the case may be. That's the so called classic cross over point in terms of your tax law and should you burn off your depreciation too early and have nothing really to do with it, it may not be very effective, after all you can carry back excess tax losses for the last three years, perhaps carry them forward five years and now today there is also a gradual evaporation of that tax shelter in which if you can't use it you lose it sort of thing.

But the second cross over point is the point at which the tax on resale exceeds the net cash over available from the sale price. You have been very clever, you have acquired the proper property, you have depreciated it, it has nevertheless appreciated in value, it's cash flows are higher, you now borrow a new loan on it. The new loan exceeds your old basis and if it comes time to sell the property, the total tax on the gain, between the sales price and your now depreciated basis, will exceed the net equity realized on the transaction because you now have a major new loan to pay. That's the second cross over point. Can I net enough on resale to pay off my obligations? And hopefully at least break-even, on the sale. Many people are locked into their property. They don't dare let go, because the

resale proceeds will be less than the total obligations they face when you combine the debt balance due with the taxes due on the sale. Therefore, tax planning has to take not only the short term view, but also avoid the tax trap of either a cross over in which your principal payment dollars are no longer sheltered or what's worse, should you sell the property you have a negative cash realized on sale. So you have to balance those two out.

Not too many years ago when accelerated depreciation was in vogue I can remember one investment real estate trust that we were working with, which had so much depreciation to burn off they no longer had any income to shelter. So we deliberately took a depreciation method which worked in reverse. You can take accelerated depreciation and run it backwards, make the very least payment first, and the largest payment last so that, as we burned off the existing depreciation, we were able to replace it with the increasing depreciation being taken on the property. The IRS is perfectly happy to go along with anything that postponed the day of deferment, as it were, of the tax, and obviously that kind of curve really represents more accurately what happens to a property, it doesn't depreciate very quickly in the early years, it tends to obviously accelerate its obsolescence and decline in the later years and so for a variety of reasons we're taking the short term versus long

term view and this is true whether we're looking at the federal or the state rule.

Until 1986 of course you always have the ploy as to whether I want to take it as income or take it as a capital gain, since the capital enjoyed a significant preference, essentially 20% of the gain as opposed to as much as 50% of the income. At one point it was even higher than that. Taxes on income could be as high as 70% on the marginal dollar, while capital gains were 25% of the net gain and so there was obviously a desire to convert earnings, as much as possible, to capital gains. Today that urgency is not there since both capital gains and operating income are taxed at 28% on the margin, which changes the game to some degree.

The ploys available, nevertheless, for investment consideration are 1) postponement of the income tax; 2) leveling of the income to take advantage of progressive tax rates; 3) shifting of the income to lower tax entities; and 4) avoidance of the income tax or capital gains tax for that matter. For example the home owners who waits until he is 58 or more, or 62 or more, (I can never remember) and is allowed to take \$125,000 capital gain out of his house and pay no tax on it, and so forth forth, it has reached the threshold to avoid the tax. If they were so crass as to move out the year before and convert their property to a rental property, they're in trouble, they just killed the

long term gain for a relatively short term advantage and so you need to be able to interplay between the short and long term and as the tax laws change, the degree to which you can use one of those ploys obviously shifts.

Related to that is the last category which we will call, the estate or distribution plan. For individuals the greatest tax ploy going, is a one time, die to win situation, in which when you die you are granted a stepped up basis, you never have to pay the capital gains tax on your estate. So you've been in that little old duplex that you bought at \$20,000 and you depreciated down the value of the land to \$4,000 and now its worth \$100,000--you're going to have an \$86,000 capital gain which if you would sell during your life time then take a 28% whack, not to mention whatever the state takes of the whole thing. On the other hand, if you die, not only does your estate get \$100,000, but the heir takes the property at \$100,000 and can begin to depreciate it on that basis and might play the game all over again. There are many people just mean enough to cheat Uncle Sam out of their capital gains by dying (laughs). Congress tried to stop that a number of years ago and in effect to eliminate the stepped up basis and found one, there were two major problems with it. One, a good number of people now approaching the point where the probabilities are good that they will in fact die, don't have the foggiest

as to what basis is and, therefore, didn't have a basis to their form, computing or not. And under the law would have had to pay the tax on the full thing even though their basis was zero. How many people for example, who've collected stamps over their life time, or coins over their life time, could tell you how much they spent for that asset over that period of time and therefore, what their basis is against its value at the time they die. Not very many. And yet they would then have to pay, under the tax law, that would presume that at one point in 1977 they would have had to pay a capital gains tax followed by then, an estate tax on whatever residual will remain and then there would be an additional inheritance tax paid by the heir on whatever they receive. Not only was it administratively a difficult thing to do, even worse it hit the congressmen where he lived. Most congressmen didn't have any money to start with, and have been able to glob onto a major estate in the process of serving as congressmen and being well rewarded for their public service, and my God, the tack is going to fall on me, the congressman they voted for, I can't have that. What if the people really had to report how much money I've made and how much money that has no basis. Nobody has more net worth with zero basis but a congressman. How are you going to prove where that money came from, son of a gun. Even legitimately, a congressman who doesn't

spend all of his campaign funds when he retired from congress is permitted to keep the balance. If that isn't one of the most disdain pieces of crap you ever heard of. If Gary Hart pays off all of his bills and retired from the campaign and retired from the senate and still had \$700,000 left in the kitty--it's his to keep. Why wouldn't you make an ass of yourself and make \$700,000? (laughter) But, from an administrative standpoint it wasn't a bright idea, and from a political standpoint it wasn't a bright idea either at a time when the election strength got switched over to the middle class who would likely have an estate. And so congress repudiated their effort to eliminate the stepped up basis. And it's the biggest single gap in the tax laws there is. So obviously there is going to be a relationship in your investment strategy, of when I acquired the property, how is it I plan to transfer it to the next generation, to my heir or to whomever? Question--what do you mean by shifting of the income to a lower tax entities? Chief--Sure, some of these ways have been blocked by the tax because it was so prevalent. A couple of different ways-- one, you're buying in the high tax bracket, which now let's say is 28%. Okay? And I happen to run an appraisal company called Landmark Research and the tax bracket on small corporations starts down around 12%, I'm better off to leave it behind to Landmark Research, right? Now, Landmark

Research in turn says hey, you can have 25% of net income go into a profit sharing plan to the benefit of the executives, so what's the better? Now you have 25% of my income invested in something that isn't taxed at all. Okay? That's the best kind of tax rate. It's my profit sharing plan. Not only that, I could set myself and Jean up as the trustees of the profit sharing investment fund and invest in anything I want to including the duplex down the street. And what's more valuable to me? Depreciation of the duplex based on the 28.5 year life, or the equity built up in the pension fund at no tax at all until such time as I either liquidate it and distribute it or whatever. Notice I'm shifting my income down stream into entities which have a lesser tax rate than I would. All right? Until this last tax law it was common to use what is called the short term Clifford Trust. Clifford Trust says that you could put a piece of income or earning asset in a trust for ten years, at a minimum of ten years, and name anybody you want as its beneficiary so my kids aren't very bright because they're not making very much money, and so they're in a low tax bracket, so I put \$100,000 of stocks in the Clifford Trust, the income goes to my darling dumplings to buy what I should have been buying for them as a parent anyway, with after tax dollars, and at the end of ten years the money reverts to me to cover my retirement, the kid's on his own. In the

meantime the income on the stocks is taxed at the beneficiaries tax rate rather than mine. The gap between that until a few years ago was enormous. If I was a doctor in the 50% tax group rate and my kids were in the 14% tax rate, and Clifford Trust was a very substantial savings. All right? Downstreaming my income to the entities which have lower tax rates than whatever organization I do.

Now of course, every time you invent one of those, the IRS counters with a new rule. So now a trust to children is taxed at the marginal tax rate of the parent rather than the child. If you would die, gee whiz you would almost think Reagan was opposed to children. A consolidated corporations would require that I tax the various corporate entities forming the conglomerate at the maximum corporate tax rate. Otherwise in the old days if I structured it correctly, I could have one corporation owning the building and it would lease it to a second corporation and they would each be taxed at the lower corporate tax rate rather than the maximum rate tax. So Uncle Sam came up with an attribution rule which decided (unrecognizable). But there are still a few little adaptation ploys which you can follow to do that.

One of the major problems with either measuring capital gains, as it were, in the case of sale or in the case of the estate tax, relative to real estate, is valuation of the assets. A real estate investor who dies must know the value

of the real estate on the day that he died and six months after that. He's entitled to be taxed on which ever number is lower. Rolled out of the 1929 crash in which people who died two days before the crash had estates of remarkable value and following the crash had estates which were less than the tax due on the value established just prior to the crash. Many had to forfeit his estate because the taxes were greater than what he would inherit. Uncle Sam in his generous wisdom said, "Gee that's unfair, what we'll do is we'll give you a second kick at the cat, you can then elect which dates you're going to value it, either on the day that you die or the day exactly six months later whichever is lower in case there is some economic cataclysm in the interim." And that's a very expensive process. Very difficult to know, first of all, what the real estate was worth on the day that you died without spending a considerable amount of money to find out. And what's even worse is that if you have to plan for the estate taxes to be paid and the liquidity of the estate, etc., etc., etc., you need to have a pretty good idea before the fact what you're going to have to pay taxes on so that if you've accumulated cash, and the liquidity factor suitable to these payments. It's very difficult from the planning standpoint. If you have real estate that is relatively elastic in value and hopefully rises in value to be able to program a balance

with your cash resources that are sufficient to pay the taxes and the value of the assets which may be largely the real estate at the time that you die. So you have a real interesting problem not only in terms of valuation but in terms of liquidity.

You may have further problems in terms of continuity. What do you do if you're a general partner and you die in the absence of any long term planning? That becomes a taxable event, that's the end of the partnership all of your limited partners will be taxed at that point whether they wanted to or not, whether it was convenient or not--whether that was the most favorable time to liquidate the partnership. So you have to plan not only for what happens in terms of your values and your obligations if you die, you may have to plan a system by which it doesn't become a taxable event. There may be certain properties in which you want no taxable event or not and others in which you do. We had a general partner who took his airplane and plowed it into a hill out here after having put together any number of partnerships and they realized there was no provision for his death. They were into accelerated depreciation apartment syndications, and the general partner died--that was a taxable event and these boys really paid through the nose. Not only did you have to pay the capital gains tax on the reorganization but you had of course the recapture tax

on the accelerated depreciation in excess of straight line, and the limiteds all had to come up with that money right then and there simply because the general hadn't anticipated that in fact he might not be around for the longer point in time. This is why as many general partnerships set up not only with the individual general partner, but with a corporate entity that will continue to survive because it has no mortality. And that way you've got the best of both possible worlds. The corporate entity may be owned entirely by the general partner. But the corporation will survive even if he doesn't, and therefore the partnership will survive. So we need to be able to look at continuity. We want to know that we are in control of the timing of the disposition rather than events being in control. We'll look at deals a little later when we start talking about estates that freeze the value so it's predictable.

Most people keep talking about syndications and partnership, and one tax conduits. The fact is, more taxes are saved by using a corporate shell than are used by using a partnership shell. The myth created by brokers is one thing, the financial reality is quite another. At any rate, when we begin to look at taxes while it does of course have a great deal to do with how we structure things, certainly under the current era in which the income taxes have been somewhat mitigated, at least the rate, and the estate tax

has been incredibly modified in favor of the middle class and the rich, and since the administration for the middle class and the rich, why obviously you have to factor that into your plan. There was a time when it was felt that it would be in the national interest to break up large family fortunes, return the property therein to the market place so that there wouldn't be large conglomerations of property in one hand, you're going to end up with feudal tenure system by default. But that is not a popular idea. Premise is, if I made it and I want to spoil the kids rotten and give it all to him, I can do that, and kids are saying yeah, yeah. (laughter) - where do I sign up for that? Tell me how to vote. Now that I'm 18 I've got the vote and one of the things I'm going to vote for is liberalized estate taxes, and as a result we have obviously a very significant shift in the tax philosophy in the way of wealth redistributions and investment maximization. But that's not only true of the individual, that's also true of the corporate entity today.

Most corporate entities are probably not designed to be immortal, they are not designed to go on indefinitely, are intended to be temporary devices with a business plan that may be 10 or 20 years long and at some point will dissolve, merge or otherwise modify their entity with an idea of getting their assets distributed. Some of those of course

are distributed to share holders, but more typically they're distributed to the officers. To understand any enterprise you have to understand who is perceived to be the stake holder. Somebody pointed out rather effectively General Motors managed to successfully pound the unions into the ground and accomplished tremendous savings and then reward the executives for that to the tune of \$170 million in bonuses for having screwed labor into the ground. That's not exactly going to contribute attitude or the long term investment quality advantage to the share holder, but most corporations aren't run for the benefit of the share holder, nor are they run for the benefit of the employees, they are run for the benefit of the officers. So we have a variety of devices for distribution of the assets called profit sharing, voting plan, stock option plans, etc., etc., all of which are designed to distribute all or some or most of the wealth accumulation of the program.

Did I tell you about the Omaha situation? Great. I get one dumb phone call a day. (laughter). Off the wall, I don't have the foggiest idea how they got my name or whatever. Yesterday's phone call, which took about 40 minutes of my time, is from the citizens group in Omaha, Nebraska. It appears that first of all there is a corporation called Ceratgo which is a new amalgamation of the Armor Company, Cargill Grain and related products

company in Banquet Hoops, NE. And they are the largest single employer in Nebraska. And they have a president who comes out of the grand old tradition of the meat packing industry, in other words he's a son of a bitch. And a year ago he put it to Nebraska, he says guys we think we ought to be a tax exempt corporation because we do so much for Nebraska and if you don't give us tax exemption we're going to move out of the state. Set the whole legislature into a fury and they capitulated and gave him tax exempt status which where upon he graciously stood in front of his employees in the Omaha plant and said, "This is our home, this is a wonderful place to be and we're not going to move anywhere." Called economic terrorism--happens all the time, its just generally not quite that blatant. Now they decided to build their corporate headquarters in downtown Omaha and they own a hundred acres on the river on the bluff that is about six blocks from the core of downtown Omaha and between them and modern downtown Omaha are some 22 buildings which are on the national historical register which architecturally most of them, I guess are having to, do to the lady and gentlemen who are calling me on a conference call, not only are they probably superior to the Midwest, but at least half of them have now been rebuilt into apartment buildings, the art center for Omaha, and a number of other kinds of offices and retail establishments,

restaurants, the usual kind of things, and while they only have four or five buildings to go they have several million dollars worth of commitments going forward to finish those. And in addition Ceratgo is required that the city create a tax TIF district and finance about an 80 acre park including a 20 acre lake which surrounds their new corporate headquarters. Part of the master plan which is being presented right now to the planning department in Omaha calls for the City to pay for the parks but it will not be a public park, it will be a private park to benefit the employees are Ceratgo. Not so much as a jogging trail around the lake allowing the natives to at least come and see where their money went, let alone paddle a canoe or sail a boat or whatever. But the crowning piece is that they insist that the City tear down the buildings between their new corporate headquarters and downtown Omaha so that they can be seen and appreciated for what they have done for Omaha--including the 22 historical registration buildings--because some of them are as much as eight stories tall. The mayor has agreed to this. Now the mayor is dying of cancer and they have sold him on the idea that this will be his memorial--he will have rebuilt downtown Omaha single handedly. And the city council was lying over on its back and probably will agree to it and the only publication they're getting at the moment is positive sales from the

publisher of the only newspaper who happens to be a golfing buddy Ceratgo and now the president of this new amalgam has said, "We promised to stay in Nebraska although we didn't promise to stay in Omaha and we'll take our 2,200 jobs some place else and our tax base some place else, unless you tear down your downtown so that the glory of our corporate headquarters can stand tall." Their call was HELP, please come and testify to the planning commission and our city council who are moving forward on this and we can't even get a hearing on it. Classic corporate contribution and distribution of net worth. I'm sure if the mayor had any gumption the first thing that he would do is buy a one way ticket on the bus line and mail it to the president of the company but apparently that's not about to happen. Watch it in the newspapers and see what happens in Omaha it could be a very interesting confrontation of classic Neanderthal corporate real estate versus a community who's having a very tough time getting organized because the newspaper is controlled by the corporate guy--should be fun to see what happens. Anyway, that was a screwy phone call yesterday.

Now, the reason I'm referring to that I guess in part is that many corporations relative to real estate and particularly for real estate investment, use it as a method of rewarding management ego, rather than necessarily a method of advancing the aims of the corporation. The

distributions may go to the public, indirectly or obliquely in the form of real estate taxes, in the form of corporate participation in urban redevelopment, in the form of perhaps hidden profit centers to those that are involved in the process. That distribution of wealth created in real estate within the corporate framework, is perhaps one of the most subtle and yet most powerful way of distributing the assets of the corporation to the executives and the insiders, without really direct control by the share holders. I would suspect that insider gains through real estate transactions of private corporations greatly exceeds the profits of insiders on the stock itself in the market. It's probably, if not more ethical, much less likely to be criminal because they happen to be in the right place at the right time. The ability to create real estate, and the ability to create power, because of your ability to control disbursements. That power may be used to the benefit of the corporation or in the benefit of the executives. A classic example is Omaha. If I'm going to build a corporate headquarters for you, it's going to have so much tax base, now this is what you're going to do for me. And that's a very rewarding psychic income for those that have the ability to control that disbursement. It's true whether you're a private corporation or whether you're public entity. Robert Moses' "Power Broker" it's a classic example of the ability to

control the politics of the entire state by means of controlling the disbursements of the Tri Borough Authority which was involved in building bridges and tunnels and urban renewal projects. And it took the New Yorkers about 35 years to figure out, you know, how badly it was organized, but obviously the power structure knew very well. Who was then involved and who was running the democratic party in New York and it was Robert Moses who could always profess that he was a public servant, interested only in the greater glory of New York City. So you need to begin to look at the distribution aims of corporate real estate just as you do with the individual. There's a new book out that I think I mentioned earlier called "Riches and Ruin in Real Estate" by Jim Powell, and one of the big name real estate developers, who was good enough at being an very intensive creative individual, but had made himself millions of dollars in real estate, had a net worth of zero. He had given it all to trusts for his children, early on, as he said as a father the last thing I wanted to do was be in a position of having three sons all waiting for me to die so that they could have their inheritance. He said, I think, just simmer that issue right up front, gave him all the money right up front. For him the kick was running the family corporation, the fact that the trusts had looked after his kids, had nothing to that issue with them, the money was already there, now we

can get on with the business of being father and son and father and daughter and never have that barrier, that doubt, that skepticism between us. That's playing hard ball football, and nevertheless, it becomes a major issue for the families that have real estate interests.

Okay, what were the seven basic categories of hope that we're going to look at, and as I say I categorized them because we get so involved in rationalization, so much of it is numbers that we can get 3 place decimals on, that we tend to loose track of how soft each of those computations and expectations really may be. And indeed, maybe not really the measure of storing our real estate investment at all. That, in fact, they miss entirely, the psychic income of real estate, and it may very well be the psychic income of real estate which is a thrill, a kick, the creative outlet, the satisfaction, the tangibility, and pride of ownership, the thrill of the chase if you will, the fun of the game, none of which are factored into the real investment decision at all. So let's not be too obsessed with the cleverness of our rationalizations about the real estate investment process.

One of the wonderful stories that Tony Downs said sells again and again, Tony Downs gets away with murder, he gets \$7500 a speech, generally about 40 minutes long, he generally has the topic of the year. I'm on the platform

with Tony at least four or five times a year, generally gives the same speech, I always hope to be there at the turning date, like the date when you go from winter underwear to your spring underwear, change in his speeches, but don't always make it. He tends to give the same story over and over, but he has a wonderful story that an elderly couple in their 80's shows up at one of the counselors on marital bliss and sex life and wants some counseling. They're not sure whether at 80 they're missing something or not, and they have a fairly intense session which the counsel with considerable observation of technique, and their marital life and he warrants that they're doing exceptionally well for their age and they really shouldn't have that lack of confidence and they're back the next week with the same doubts and go through another session, and by the third week when they're coming back, why the counselor says now wait a minute there's something that doesn't make a great deal of sense. I've tried to reassure you but you're certainly living life to the fullest and I don't understand why you keep reappearing. And they said well, actually they said they had to confess that a \$50 an hour session with him was considerably cheaper than a motel room, that they couldn't go to her place and he couldn't go to his, and that furthermore they could charge this to Medicare. And he said in real estate the basic principles that you needed for real

estate investment today you have to have creativity and imagination. You have to have some sense of cost control and a real knowledge of government regulation. And then on that basis you could move into real estate investment as well as a happy old age. What we really need to begin to look at is that kind of program, creativity, cost control, and ultimately a knowledge of government regulations.

The investment market goes through various fads which really aren't investment and quite often get confused with investment. We went through for an era the finance driven investment--golly, I can borrow more money with real estate than any other way and therefore, if I can get a 30 year fixed interest rate loan, ultimately I will rip off the saver because as interest rates rise I enjoy significant advantage relative to those that actually saved the money and made a loan to me through an intermediary such as a savings and loan or a bank and the finance driven investment really wasn't an investment at all, but really was simply an arbitrage between the cost of savings and what I could make on the borrowed money. Commodity speculation not an investments really, the second level of real estate investment that we went through was the so-called tax revenue investment. That if I could create sufficient depreciable assets I could lose money and make money, as long as the cash lost per year, was less than the tax

savings to other income, I was still doing well. And the tax driven philosophy is not obviously what real

estate investment is all about. We just recently completed what I would call a fee driven investment. The professionals pushing forward on projects in which they enjoyed an architectural fee, an engineering fee, and a contracting fee, and a syndication fee and a counseling fee and a marketing/leasing fee, and God knows what else they milked out of the project. And if the project fell flat on its face that was unfortunate, but the fees were at least into other entities that had not signed on the line. None of those are real estate investments. We also have a subsidies driven investment. This isn't a bad idea, but if I don't get my share of government subsidies somebody else is paying too much for it philosophy. This is what you're seeing going downtown. I don't blame Mr. Mullin, if the City wants to subsidize my hotel at 47 different ways from Sunday. Why wouldn't I sell them a hotel they don't need? We're all jealous of the fact that he's there first and if you're going to dip into the honey pot of municipal works funds.

So what we're really looking for is an investment that has two basic rational objectives if we take away psychic income. We want to evaluate the investment to the degree that it increases our spendable cash, or it increases the liquidating value of our net worth. If I look at a real estate investment to the degree that it increases our

spendable cash, or increases the liquidating value of our net worth, that is a legitimate objective of investment and those other elements may play in some part of that but are not the reasons for the investments. When you lose site of that, you lose your shirt.

Classic appraisal theory made some rather severe assumptions about that process. If you look at the classic income approach, capitalized value--it said net operating income of the property was constant, or would fall along a mathematically predictable line. That we could divide that by a capitalization factor which includes one, a constant return on capital and a recapture of capital. Three, that the investment was always an instant investment--all of the money went out, boom, at an instant rate. Not unlike calling up your broker, making the deal for a share of stock and closing on the stock by sending them a check. There's a fixed point in time when all the money went out the door and you were now in the investment. And correspondingly there was a fixed point in time in which you exited from the investment. And, finally, you held the investment for its entire useful life. In short you acquired a wasting asset. And appraisal was concerned as the economist was with the asset value created. If after you spent all that money, was the present value of the benefits equal to or greater than the present value of the outlay, if so, they have a

legitimate investment. It was asset valuation. Now think about that for a while. The economist and the appraiser at that point were really concerned with, do we need a marginal dollar of investment in let's say, a steel mill or an apartment building or so forth, or did in fact the returns at that point start to fall to a point where investment was no longer justified and we should really be allocating those dollars of capital to something that would presumably justify the investment in the capital. The investment model, the capital asset pricing model if you want to call it that, was in fact a way of allocating and rationing capital to those things which justified the use of the money.

And along came a guy named Ellwood, but he really spoke for lots of folks who were thinking about it, and he was a mortgage lender, and he still had that fixation that all of the money went out the door at the time of closing. So he didn't have any problem with the fixed point of investment and some fixed point of disinvestment or sale. But he did have some problems with the idea of holding the assets to the end of its useful life. He said that's kind of unreal. As the asset of operations become better known of we'll run finance, we'll sell, we'll modify our position. A five to ten year forecast is about as long as we're going to be in a real estate investment, and therefore, we really ought to

adjust our investment in such a way that we expect to get most of our capital back from resale rather than income. Therefore, our capitalization rate need not emphasize the recapture factor. Indeed, since both of us are now experiencing inflation, we might even have a negative recapture value. In fact we may get more capital back on resale than we ever put in the deal in the first place. So far so good? Furthermore, he said, that we're really not interested in an economic opportunity cost of money sort of thing under an asset management model, we really need to recognize the different sources of capital because they have different levels of preference of claim on the income, they'll have different costs. We can have the first mortgage and an equity position at the minimum, and that the first mortgage because of its preferential position probably will charge less in interest than we can earn on our money, then it will be positive leverage if you will, there will be an equity buildup to the benefit of the equity as we amortize the loan not on a basis of whether the asset is depreciating or not, but simply on the fact that we're amortizing the loan according some financial schedule. And we may have more than one loan. And we may have more than one kind equity interest. We may have a preferred equity interest which in the stock market we call preferred stock, and we may have the residual equity interest, which in the

stock market would be common stock but we can call that different kinds of residual partnership positions and we can have different splits of the ongoing operating income and the resale value of the property and so forth in real estate, but in any event we have a series of claimants on the income stream with different levels of preference. And if we introduce that idea, than what he's really saying is that real estate is the sum of the present value of the claims on the asset. It's the sum of the liability. Real estate value doesn't have anything to do with the asset productivity. It really depends on the arbitraging of different discount rates for the different sources of capital. If lenders want only 8% on their money and equity investors want 10% on their money, the more we can borrow the higher the value of the property. It has nothing to do with the net asset value. It has nothing to do with the net productivity value. The income doesn't have to change. Only the perception of those who will share in the income has to change, only their shares, and how they perceive the risk and the discount factors they want to apply to that risk. We only have one capital asset pricing model. Every interest in the real estate has its own capital asset pricing model. There will be slippage there, there will be arbitrage there in terms of the risk perceptions. And so we move from looking at real estate as a productive asset to

looking at real estate really as a manipulation of liability.

That proved to be a disaster, in terms of the real estate investment trusts and many of the other groups that were very very clever in structuring their financing for short terms but watched it come apart when the commercial paper rate went this way or the interest rate went that away, or people changed their risk perception. Last week in Dallas we went through a lot of data which shows that in Dallas camp rates are 75 to 100 basis points higher than the rest of the world for a leased building. That's the way people perceive Texas and the Southwest as a different rent risk category. Obviously if not all investors perceived the same risk, there's obviously bargains to be bought, and people are traipsing in from all parts of the country seeing if they want to buy an office building in Houston or apartment buildings in Austin, or wherever--simply because the differential now has perhaps exceeded what people perceived as an appropriate risk adjustment for that area.

The third position, however, is the one that we're really talking about in real estate investment today, changes in net worth, change in spendable cash. And the traditional assumptions are abandoned. First of all you would trickle into a real estate investment. You paid an option on a piece of land, maybe you sell off a little piece

to somebody that wants to develop a small portion for something or other, and that gives you enough money to find an architect and a developer to joint venture, you get their money in first, you trickle into an investment. Often times, though not totally true, there is no fixed point as to the point that you are now invested. And by the same token you can do, kind of clamber out of a real estate investment. It takes you a while to search for a buyer and then the buyer wants certain concessions or you gotta clean up the property because of the asbestos, which means you put a little money in in order to get out. And finally they want sellers financing, and they want an escrow account to guarantee that the certain warranties you made are true, and you extricate yourself over several years span of time. Gone is the nifty fixed date in, fixed date out. Which really came out of the bond psychology of many real estate investor in which there was a date in which the interest coupon rate started to run and there was a maturity date when the bond was payable. You know, neat little given calendars of events which could be programmed into your investment. Those don't exit in real estate. The real estate investment you trickle in and you kinda extricate your way out.

The next problem of course, is that income is no longer predictable along a mathematical line. We don't deal in

normalized and stabilized income statements. Part of the reason for that is that for the equity owner, some of his profits aren't even in the net income phase. Many of the equity owners returns are in the expense stage, because its his construction company, and leasing company, and insurance agency and others that are taking a small profit as the dollars pass through for performing the services that are necessary to make the property operate and create the property in the first place. Highly irregular income from period to period, depending on what kind of expertise are required, depending on what the tax bite is, and for that matter, depending of course on the lease. I've got a five year lease in which the first 18 months are free. That puts kind of a kink in your income stream. The only way to account for all that is on a cash basis. There is no way that accrual accounting can tell you really how you're doing in that case. So when we say spendable cash, we mean cash, we do not mean accrual accounting. Real estate investment and accounting fraternities are going in opposite directions at the moment. The accountants are going back to economic productivity, which is asset management and asset measurement. The real estate fraternity is going towards cash management. And there's a fundamental clash brewing in fact it's already out there, is how do you report that?

Someone asks a question. They're concerned with the net worth of the bank, not whether the current operations are solvent. So maybe life's a series of short runs, maybe it's much more important that the bank is currently solvent in making money or breaking even, as to whether its measure of value versus liability tells you anything. The major banks in Texas are solvent but they're probably not having positive net worth. So which do you want? So we're interested in cash management for real estate. And it's a highly erratic kind of cash management. So the classic capitalization rates divided into normalized net income really aren't very relevant to anything in terms of investment value. When you really need to know the present value of cash. And specifically we need to know the present value of distributable cash because a real estate property of any kind is a small business operation and as Mr. Drucker has pointed out in one of your articles, in periods of uncertainty, the enterprise needs more and more cash to provide for working capital, to provide for asset enhancement, and maintain its competitive position. To provide a cushion as it were for short aberrations in the revenue line, because tenants move out and obviously need money on whatever. So you need working capital and we're only concerned with distributable cash, spendable cash, that's the meaning of the word spendable. If we can

sprinkle it around some place other than in the business. And obviously that's going to occur on a quarterly basis or an annual basis or whatever.

Ultimately, the rational investor probably wants to accumulate a net worth, probably I should say. There are a few that say, being of sound mind and body I spent it. Therefore, I leave my heirs to conscious but unremitting regards. Perfectly legitimate position. The emphasis is entirely on spendable cash. Weight placed on net worth, zero. Obviously most investors have some other balance that they wish to set between spendable and the so called liquidating value of their net worth. The term liquidating value means just that, what's the cash value, what can I exit with by taking my cash and going? And that becomes the other component that we're trying to measure. The point in time of course, is a critical issue, am I going to do this annually or I am going to do this only when I depart this fair earth, or am I going to do at an selected points along the way? But one of the critical problems of real estate investment today is deciding how often you should take the temperature of your investment. The mind conditioned by the stock market wants to look in the paper every morning and decide whether you did well or not yesterday. I could never figure that out. A guy owns 100 shares of stock is going to decide whether he's going to buy lunch today on whether it

went up a point yesterday. At the same time you have a bank rule which until very recently said that every month the bank must report the value of the trust assets. Conditioned by a time in which you could look up in the paper that the bonds went for so much on that date, and the stocks went for so much on that date, and the CD's went for so much on that date and so on. There's something about real estate that one, the evaluation process isn't that precise, nor is it that inexpensive. Those banks who in their generosity said, don't have to determine the value every quarter, golly. If you look at \$100 million office building and you try to measure how its productivity and its value in the minds of the next buyer has changed from three months ago, come on guys, gee whiz. I looked at one the other day a bank building which was worth \$42 million in January this year is now reported by the appraiser, the same appraiser, to be worth \$34 million as of a week ago. And yet the number of tenants in the building went up. There's something wrong in the process there. Maybe we ought to just let the cake bake in the oven and every three years take a peek at it. How are we doing? Has the liquidating value of our net worth gone up? It's a really tough problem in real estate to measure performance of the asset. Because if you keep looking in the oven too often the cake will fall. And if you look at the real estate from day to day it is tough to

see what are we doing wrong now. Down at the Investment Board it has what, \$300 million a year in real estate? And out of the three hour meeting you have to spend an hour and a half wondering what the hell happened to the pet shop at a shopping center in Southern Florida which rented all of 800 sq. ft. and we're representing a monthly income somewhere in the neighborhood of \$800. And they were really upset with it--pet shop has gone away, what are we doing about that? Who cares? But then once real estate concerns with that quest, that you don't go with a sense of historical flow. Those with a sense of history about real estate in the making, have no real problem with the fact that they really don't know the underlying value from year to year. That in fact it may be better if they don't where they're at nor do their creditors. I looked at 15 major apartment projects in the City of Madison that were syndicated in 86 and 85, and 87 and there isn't a one by today's appraisal standards that has a positive net worth. That if you value them on their current net income, using reasonably liberal cap rates, the 221D4 mortgages are all greater than the appraised value of the property. So are investors loosing their butt? I don't think so, most of all since they have other sources of spendable cash, so its not a major problem, I guess I'll go to Florida and lie in the sun and figure in another year or two the values will be back up because interest rates may

have gone down and inflation may have made it impossible to build that and more folks will have moved down and filled up the vacancies. Ho-hum, why worry. You gotta go with the flow. That's very hard to in real estate if you've been conditioned on stocks and bonds and looking it up every morning, it's just isn't going to work out very well. You and real estate are not going to be very compatible, but you do need to have a sense of the order of magnitude as to where you are on the liquidating value of your net worth, you won't need to plan your estate taxes at an unexpected and relatively abrupt moment.

So spendable cash, and the liquidating value of your net worth is really the rational framework around which we'll try to build a real estate investment program, and the more you want to emphasize one over the other, the more concerned you are with precise measurements of one thing or the other, we'll change the structuring, we'll change the choice of investment form, but we'll stick with those kinds of investments which essentially are backed up by equity assets, as opposed to mortgage assets although occasionally the mortgage will creep part of that flight. Okay, I quit, I'll see you on Monday. All of you should have received by now 795 schedules....(fades out.)

Computer stuff administration.

The subject matter for today is laying the groundwork for cash flow models. Certainly there once upon a time when we began cash flow modeling projects generally had rents and they had operating expenses and they had net operating income and there's a principle deduction and that was pretty much it. Then if you added back the principal and subtract the depreciation you were at taxable income and then all you needed to do was compute the taxes and presto you had cash available for distribution. Things have become more complex and see, twenty years that have past since that basic insight to the real estate occurred, and while we all tended to do ____ (can't understand tape) _____ to the abstract idea that the present value of the investments would be the differences between revenues and outlays, nobody really made that operational. Today a cash flow model of any form which presumably is going to represent first, the change in our spendable cash, second of all hopefully the change in the liquidating value of our net income or liquidating value of our assets and that should begin to account for the receipts and hopefully far more detailed back. They must also do it by converting quite often, the traditional accounting GAAP format to a cash accounting view of life. Ultimately the investments boil down, the cash in, the cash out, what falls out on the bottom line in the way of cash after everybody else got theirs including Uncle, the state, the

local community and who ever else had some prior claim on that cash stream, and that is what the investment boils down to. If you talk to Northwestern Mutual, they may have a land lease on the program, they may have a project, that may have an equitable interest in the corporation that owned it, they may have a first mortgage with some sort of income participation featured, but when they report it ultimately the investment committee, it comes all the way down to here were the negative outlays for a period, here were the positive cash receipts for a period and while the accounting may have made significant differences in terms of the regulation of their institution and perhaps the tax impact of their position when all is said and done they simply want to know which periods were negative, and which periods were positive and by how much and now if they want to convert that to some sort measure such as modified internal rate of return or some other cash-on-cash ratio, wonderful so that it's quite discouraging to take a real estate project and first explode it into an infinite number of accounting categories and timing periods etc., and then implode that to point where you aggregate everything down to a fairly basic notion of when did the cash go out and when did it come back, and nevertheless that is ultimately the essence of it. Much of the illegal structuring that goes on after that is simply to create artificial risks and regulatory categories

with which one can deal in traditional accounting formats rather than necessarily investment formats.

So now if we look at the one handout I just gave you, expected receipts can come in a variety of forms for rental properties. Base rent. On the cash accounting basis the base rent would be level if I signed a contract for \$50 rent over a period of five years but it wasn't due and payable until the third quarter of the fifth year, the income in the first year would be zero, the income in the second year would be zero and thereafter it would be presumably somewhere in the neighborhood of \$18 and something per year. \$18.33 I guess, to be exact. And GAAP accounting would have fits over that. As far as they're concerned your income is going to be \$10 a year over the five year span. That won't do you much good if you're looking at an investment standpoint as those first couple of years really represent continuing investment in the property from negative cash flow. The base rent monthly obviously may be sculptured to fit the season of the tenant and maybe sculptured to fit the fact that the project is only partially done and that abatements are being provided because the parking ramp isn't finished, or all the tenants major anchors aren't in the shopping center, or perhaps the civic improvement that were to provide truck access to the property are not completed

and so on. But in any event you need to understand how that base rent works out on a cash basis.

Today there's typically an index to that base. That index obviously will have different points in time when it kicks in it converts the base into what we call a step rent. And it will gradually step up, occasionally it steps down. In the late 60s and early 70s it was fashionable largely because of Ellwood--the Ellwood tables as you remember had a supplementary table in the back that said, "Gee if you release it at 50% of the original rent, the 21st year you will get this additional deal to equity and so forth and a lot of people structured it that way so that it steps down which are obviously disastrous currently as the tenant has the option to renew the lease at a rate which is continually falling and at absolutely no relationship to current market rents on the property at all." And next time I'll show you that provides some significant opportunities as it may be, for buy low sell high, but in any event the index to base rents becomes a very significant factor in the risk analysis for two reasons. One, you'll need to have some sense of how that parallels the potential devaluation of the currency over time and secondly how does that in fact determine the cost of occupancy to the tenant. If it's stepping up too quickly all you're doing is guaranteeing that either the tenant won't renew, or that he'll go broke or that he'll

find some device to break the lease. And somehow wiggle out from what he finds an onerous rent. For example the state's initial occupancy of the πR^2 Square, the step rent there was such that given the fact, one it's a loosely building, and two, the landlord wasn't in fact correcting his very significant physical deficiency, and three, the step had taken several dollars a square foot over the market rents available for much better quality space then the State went to war, broke the lease and moved out. Leaving a mortgage in default and equity that got wiped out and a very real problem for the Village of Shorewood. So you need to be able to look at the index not only in terms of how well you're going to do in the future, but what risks that creates in the project per se and to what degree is the value you're paying for that property dependent on achieving and collecting those adjustments.

We come back to looking at the Dilmore componentized approach to life, one of the articles found in your reading package. Percentage rents most of you are reasonably familiar with, tied to the retail sales. Percentage rent for the investor is a clue again, as to the character of the property and its risk attributes. Many properties that were leased in the 70s on the early 60s are generating large dollars on tax percentage base. That doesn't mean the tenant is necessarily doing well, it simply means the base

was set so low that as inflation perhaps exaggerated the gross sales and so forth, the percentage rent was reasonably attractive. Convert those percentage rents back to dollar per square foot additional rent, add it to the base, and you may find you're still well below the market. By the same token the absence of any percentage rents at all from a lease that anticipated that there would be some, may not be a negative factor at all for the investor, it may in fact be the clue to opportunity. That here is a tenant that would be happy to go if somebody would let him, maybe he doesn't know that that's one of his options. There's a wonderful line about the young man coming to pick up his date for the evening and the father scowls at him and says, "Young man are your intentions honorable or dishonorable," and there was silence. The father looked at him with a glare and he says, well sir he says I'm thinking, first time I knew I had a choice. It creates tremendous value for property by taking a tenant who is laboring under the lease, who may be perfectly honorable and never thought that with four years to go on a bad lease that somebody would say, "Gee Charlie, maybe you need a smaller store in a different location or you're 64 and close to retirement, maybe we can help you into your retirement. How would you like \$50,000 to go away?" And the ultimate down in West Palm when I invited K Mart to pay us \$100,000 to go away, instantly increased the

value of the guy's property by at least half million to a million dollars simply because they hadn't paid any percentage rent, they weren't doing very well, they overlapped two other K Mart stores. The fact that they were seeing percentage rent was an opportunity from the investors/buyers standpoint. May have been the whole ploy of buying that particular property. So you want to look at these items not necessarily because they have a specific dollar amount but you want to look at these items in terms of what do they tell you about the tenant and about the upside, downside risks, of the property. That's a critical element.

The next point is amortization of tenant's improvements. A good many properties that look good from the standpoint of gross dollars of receipts, from the sellers standpoint are hurting because he has to release against current operations obviously a great deal of tenant improvements that he paid for in order to get the tenant in in the first place. Asset management is your ability to buy future income by making tenant improvements now. For the individual going into the deal it's a sunk cost as far as the seller is concerned, so you don't want to look at that aspect, you look at the tenant improvement component of rent as simply additional cash flow and it's quite possible that you'll be discounting that component of rent which

represents tenant improvements at a much higher rate and therefore, discounting significantly the sunk cost as far as the seller is concerned. Flip it around the other way, what if the tenant improvements were all made by the tenant. Nothing is built into the rent and in a strong sellers' market the tenant gets that work done. That tells you a great deal about the quality of the lease and the security of lease. That tenant isn't going to take a walk on his creditors possible afford not to. The small specialty shopping center in which Ma and Pa have a sewing shop and somebody else is selling knitting materials and third one has a hobby shop and so forth, you want to get those tenant to invest heavily of their own money in that property, they'll work at that property if they're making \$2 an hour rather than take a walk on it. In effect, you have a very back handed subtle kind of guaranteed fund built into the project because the tenant finished it off at the time going in. So the fact that there's no tenant improvements built into the rent may also be a desirable factor if the tenant has made significant investments. Or an apartment building for example, which rents on a three year basis, may be a little under the market in terms of base rent but if the tenant put in his own carpeting and his own dishwasher and so forth and so on, you have very stable occupancy because they're not going to go anywhere and leave that behind. So

look at each one of these in terms of whether there's a potential risk component, and in Ellwood instability in the future of the project, or whether it really represents a statement of opportunity for the investor.

The same is true of common area maintenance (CAM). Common Area maintenance fee is often contained, as you know, a profit margin for the management. Typically 15% or 20%. You want to be careful as an investor that you don't let that profit center drop into your net income line and capitalize that at a capitalization rate appropriate for real estate but not appropriate to running a small bill me Monday accounting firm. That profit center has nothing to do with the real estate, that profit center has to do with a service component that means you've been out collecting the funds and hassling with them on the books and all the rest and that 15% or 20% is a temper profit center and should not be bought at the same discount rate that you apply to real estate. By the same token the investor wants to look at CAM agreements to see the degree to which they include various aspects of relatively high risk in the project. At one time CAM agreements covered essentially the external maintenance, the striping of the parking lot, the operation of the lights, the snow plowing, the plaza maintenance, that kind of landscape matters and so forth. It had relatively little to do with the interior of the building other than the

possible exception of the lobby and today of course, it's canned, you collect in advance, monthly and the thirteenth month adjustment for over or under absorption as the case may be, and of course get your profit monthly and so forth, it's desirable as far as the developer and owner are concerned, they have lease agreement which put everything in CAM. Go down to University Square virtually everything in University Square is in the CAM account, with the exception of some air conditioning units which the architects and the leasing guy weren't coordinated on. The architect has a couple of air conditioning units servicing more than one store so that it's getting impossible to allocate the costs of responsibility for those to a single tenant which is a classic case of too late smart and that the leasing got sharper and sharper and allocating costs and somebody forgot to tell the architect about it and as a result now you have a mismatch between what's physically possible in terms of accounting allocations and what is financially/legally would be desirable in terms of those allocations. CAM, reimbursables.

Reimbursables generally involve an outlay by the management, the ownership, that can then be recovered by proration in one way or another to the tenant, typically on an annual basis, so you have a tremendous lag and float problem. You make the expenditure let's say in June and

August and son of a gun now in December we add those all up it's January before we got the bills out to the tenants, it's February and March before they have paid us again and the landlord or owner investor is obviously banking those in the interim.

Escalators with a stop may be a blessing or otherwise depending on what level the stop was negotiated at. Everybody know what a stop is? The landlord pays up to a certain point and stops, so if you'd agree that's \$2.50 a sq. ft. when the classified expenses under that stop clause reach \$2.50 at that point they shift over to the tenant. Many buildings particularly the buildings leased to smaller less sophisticated tenants often set the stop base on the first year of operation, which in the case of the new building means that real estate taxes are relatively low, you get your real estate taxes lagged by a year. You start your project on January 2nd and you finish it in September, the assessed value in January 1 for the succeeding year's payment is the value of the land on January 1. None of the improvements go up on the tax roll. Now if you can collect from your tenant one-twelfth of the estimated taxes wonderful or you can say, "Gee, look at that, stop in the first year expenses only \$2.47 and the stop was \$2.50 and you didn't pay anything and why on the following year now the real estate taxes come in and \$1.25 a foot jump right

off the bat." In other cases many of the buildings stop provisions have been indexed in years past. So even if you come into the project today, you'll find the stop clause index must pay off 1980 or 1978 so that the appearance that you're paying \$3.50 sq. ft. is just that. The stop clause has long since been operational and you will pay the full boat above \$2.50, \$3.00, whatever it is. Again, the investor coming into the project needs to read those leases and find out where that stop clause kicks in and where the tenants are on that. Again, there may be a way out of there. If a tenant is particularly irritated about something or wants a new store front or needs other factors to negotiate their way out of the stop clause this onerous and given some other intangible element.

Today, as we learned in real estate finance, many buildings are required to have reserves. FHA would require on all subsidized and 221D4 projects that a certain portion of revenues be set aside in a sinking fund that is available for short term modification and renovation of the project. They control the principal, but the interest being earned on the account, belongs to the project and can be swept into the project and can be capitalized in the income stream for mortgages and valuation of the property. Indeed the wise seller pays to get you to first of all to set a price on the property, and then when you get your closing statement you

discover that in addition to the price of the property you are now buying the reserve which travels with the property. HUD would not let you cash out the reserves simply because you sold it. As far as HUD's concerned it's there to protect the mortgage and the sale would essentially transfer the right of requesting to HUD to use the funds to the new buyer. HUD would then approve capital expenditures for deferred maintenance or asset enhancement, and those funds can be substantial on a project that's been around for 10 or 15 years. In projects which do not involve HUD but have let's say a significant component of relatively depreciable property, a hotel, or a restaurant, or something similar, the lender may require a satisfying sinking fund. In properties that you purchase as an investor which have yet to meet the occupancy clauses that are required to generate the full amount of the financing and so forth, again, there may be reserves which are generating interest. The interest can be swept into the income pool of the property.

Government transfer payments, some of which may be negotiated, some of which may be deferred in one form or another are also available for the benefit of cash flow. For example, in Minnesota, the TIF Fund which might be created by the difference of the project, may be able to pay directly into the income stream an annual amount of money necessary to carry financing for the project that made it

possible when the basic income during the early years of the project would not have been adequate to provide the leverage necessary to go forward with the project. It may well be that the small business administration has guaranteed the lease of the restaurant on the first floor and guaranteed the timely payment of that, and even though the restaurant may not be doing well, it may not be making its payments, the small business administration will be making transfer payments to the enterprise and so on.

In effect the receipts of the real estate investment today are much more complex than something called rent roll and our clues not only to the potential cash revenue of the projects but also to the opportunities of the project. The asset enhancement possibilities or in many cases the leasehold elements. And once one understands those, you can make some very different kinds of deals that don't fit what the Institute of Appraisers say is value and so on. Let me give you a couple examples. One you probably heard me talk about before is the old Sears Roebuck warehouse out on Fordem which was done by a local investor who wasn't very sophisticated in fact had a knack for making the wrong contracts I think for real estate left his children with an estate full of properties everyone of which was a disaster. Maybe with one or two exceptions, that accidentally turned out all right, and in that case he essentially had gross

rent lease on that warehouse with Sears made in the early 60s and then refinanced it with an adjustable rate mortgage, so the mortgage is going up, the taxes are going up and so forth, he had agreed to replace the roof and do all new exterior maintenance, all those kinds of preventional clauses. By the time he had died it was at a break even basis with interest rates rising, the group was now 25 years old and expected to leap momentarily. Sears was really no longer using the building except on a very small corner for an appliance repair shop and had leased out the remaining space at market rents to a point where even after all of their payment they were making money on the warehouse and enjoying their appliance area for free. The estate appraisal indicated the value of the warehouse was a million dollars at market rent of which there was a \$900,000 leasehold value to the benefit of Sears and a \$100,000 net equity value, which the IRS challenged and when they perceived the box that the estate was in concurred, particularly with the roof coming up for repair, and the estate having no money. But if you understand Sears they don't want to be in penny ante accounting and real estate business. So we simply wrote Sears a letter after they had tried to sell the building a couple of times to others, and we said, "Hey, you got a \$900,000 interest in the building but you are going to have to be in that rental business to

the year 2017 or whatever it is, which is a tough way to earn a buck. You must have other things to do with your real estate staff and so forth, tell you what we're going to do--we'll give you our equity for \$100,000 and make a \$450,000 payment for our share of your leasehold interest and for \$550,000 you can buy a million dollar property. It was a good deal for both sides. Notice it enhanced the liquidating value of the net worth of the seller. It certainly enhanced the liquidating value of Sears, whether I couldn't sold the leasehold thing for very much anyway, because who wants to buy into a property that's going to evaporate in the year 2015 and what's more you're not sure whether the landlord is financially strong enough to maintain it like he said he would anyway. You need to look at both sides of the situation as an investor to see whether you can't reshape that revenue line, add to the seller or the buyer.

Property which our fund owns down in Phoenix had a Woolworth store on it. And the Woolworth store went out of business for one reason or another and released to a home lumber products group at a significant rent over and above the base rent that they were paying. Let's say that they were in some years back at \$1.60 and the new tenant is now at a \$4 base, pays their own operating expenses and so forth. We went in simply on the basis of a couple of legal

cases which said hey, if you got a percentage lease clause in it and all you're doing is paying base rent and not producing any percentage rent and at the same time you're making additional income from the new tenant, that has violated fiduciary character of the percentage rent clause and therefore you have to pay them their share of the take over and above your base rent. Now first of all we enforced that, then we back on 'em and said, "Hey you guys really don't want to be in the real estate business in Phoenix. So what will it take to get you out of the property?" They said a million we said five hundred thousand, we settled at \$600,000 and created \$2 million worth of value for the property by taking the sandwich out of the middle. So the revenue line represents the source of opportunities, as well as source of risk as far as the investment is concerned. And we'll spend more time talking about risk in just a little bit.

The loss of potential receipts obviously is a significant element. Vacancy losses today are certainly one item, but more likely today are the concessions. In a chronically over built market the necessity of competing for tenants by providing concessions in the form of tenant improvements, lower rent during early years, reshaping of the curb, sometimes even participations in the bottom line of the project has much more impact on the net receipts than

perhaps the vacancy problem does. Vacancy losses of course include not only loss of the base rent, percentage rents and so on, but today also represent significant losses in terms of some of the reimbursables and so on. But one of the interesting features of CAM is that the well drafted CAM clause distributes the burden among the existing tenants so with 80% occupied you're still collecting 100% of the CAM expenses. In this case the tenant is going to come back typically represented by a tenants broker and say OOPS hold everything here, 95% occupancy is typical for this project and therefore I'll pay my pro rata share for the first 5% vacancy but after that vacancy losses are paid by the landlord and he protects himself from having increasingly high CAM expenses as the project becomes less and less occupied.

Rent collection losses today are a major encroachment. Rent collection losses stem from the nature of the tenants, do they have the resources to make good on the contract amendment. With the majority of the tenants today being relatively small, service oriented enterprises, they typically don't have the net worth, nor the inclination to pay the rent if they don't keep the pace. If you have a law firm or an engineering firm, and of course this what happened in Houston and Dallas and so forth, most of the offices were occupied by service firms, professionals,

engineers and so on that were involved in some aspect of the oil business. At the end of the year the partners divided up the profits and distributed them. They maintained whatever net worth was required to operate the office and they don't leave assets behind in a corporate shell, not only because they don't want to be liable for rent and so forth, what's worse is they could be liable for professional consequences of what they were doing and the cheapest form of protection against professional liability is a good corporate shell so that when they're sued there's nothing there and you're relatively judgment proof. So when the oil business went to hell there simply wasn't the staying power in the tenants, not to mention the will to make the payments on the loan. It doesn't matter if he had a 10 year lease from the XYZ engineering firms that employed 100 people at the time they signed the lease. What really mattered was they had a net there and cash available in terms of working capital and so forth was really \$300,000 and that was adequate to cover two months rent and after that they were gone and you had this nice piece of paper that said they owe you for another four and half years but it's not collectable and therefore, you really need to evaluate your tenancy in terms of your ability to collect. Some of you saw the appraisal in 856 with the Coast to Coast store, there you have a national credit on the basic lease who then has a

style subleased it to the local operator entrepreneur and after he went on his way Coast-to-Coast was still continuing to pay the rent even though his lights were out and so on. So you need to look at the potential for collection losses that are eroding the expected receipts.

Receivables also become an interesting asset to be acquired. Some managers are better able to collect past rents than others. I've seen a number of buildings in which the net rents were 105% of gross rents because the new management was so effective in collecting, the collections losses from previous periods. In any event you need to analyze all potential sources of losses of receipts to come down with the actual revenues from operations. The gross outlays from operations are relatively apparent obviously, but it is extremely important that as an investment you never net those out, you never report CAM as a net item because of the time delay between the time you make the expenditure and the time you get the receipts. Now in the case of CAM they're generally ahead of the tenant, they're generally getting 1/12 of the cost long before the cost is incurred, that's what you try to do obviously depends on the seasonality of it. Reimbursable, just the other way around. You generally collect considerably after you actually made the expenditure. Escalator items also typically are over and above a base cost.

Owners costs are a tricky item. More investors and appraisers fall afoul of that than any other item and it's important for you to delineate what is the entity that I am evaluating? Obviously the first entity, the goose that laid the golden egg may be the real estate. The second entity however, may be the partnership or corporate entity that owns the real estate. And the third entity may be the entity which owns an equitable position in the real estate. Each of them has certain management costs. If I were to own the property outright as an individual and I've decided my management costs were 6%, they could be all charged to the real estate. But if I own the real estate in the partnership, the actual costs are about 5% of the partnership and the accounting and liability costs are charged to the partnership, in other words the real estate as a functionally operating entity has one set of costs, the ownership entity has a second set of costs. Communication with the partners, legal tax finagling with the partnership and so forth and so on and finally you're down to a distributable revenue to whoever owns it. But now if I have an asset manager in the way, the asset manager may be nicking me for another 1%. The asset manager is getting paid for having selected this investment, and monitoring its performance, and providing other advice and so forth to the investment side. You have to be very careful in looking at

a statement in terms of the potential investment receipts as to whether I'm on the right level in terms of what I'm evaluating. Am I evaluating the real estate, am I evaluating the partnership, or am I evaluating the performance of the commingled fund which happens to own a partnership as a result of being advised by an outside advisor to own it. There's considerable shrinkage obviously as you move through that process.

The fees charged today for management of the asset are incredible. In fact once you see those you'll decide, "Gee, I don't think I want to own real estate I just want to know folks who do. I'll advise them and make them feel better about it." Just a selection of which commingled fund to buy and monitoring it is worth ten basis points a quarter to Frank Russell or somebody. So they take in \$20 million worth of real estate and ten basis points a quarter on that's what? \$20,000? Right. So you get \$80,000 a year for telling you what it is you should have bought and how it is it's doing once you bought it. And the hold harmless clause on that is pretty good. There's no guarantee that it's either going to go up or down or sideways. Any operating errors those are the problems of whoever is really operating the real estate and so forth. You build up a good portfolio of management you can do very well. You can spend a lot of time interfering with the managers and still have a net for

the year. So you need to know what the owner's (end of side one) costs are and should they be allocated at this particular level of an analysis. Refurbishment is typically something that is left out of outlays for operations but if you think about it it really is simply an ongoing expenditure which doesn't fit the annual fiscal period kind of thing but it's critical for maintaining market position and stability of the revenue stream. The hotel with its refurnishings, the apartments with its persistent upgrading of the facility, and for that matter for an industrial building or retail building the continually upgrading of the HVAC and the other relatively volatile operating costs become a critical element. Too much refurbishment means somebody chinsed obviously in the construction of the building. Judge Patuba (?) of course used to rebuild the building out of income, and he built such a shoddy building in the first place why you could see expenditures on his outlays for insulating the building always seemed to me that would be original construction cost and exterior painting, doors. The First Wisconsin had several cases in which Judge had a chattel mortgage on the door and windows which had to be added later after the project was built. The quality of the original installation was unacceptable.

Tenant improvements for renewal--renewal lease commission obviously become significant outlays. Property

management is concerned with executing today's contracts. Asset management is concerned with buying tomorrow's contract. You buy that obviously by acquiring new tenants or renewing existing tenants, by refurbishing the property, etc., but they are all part of the real operating outlays of the property, and it comes down to total cash from operations. Again the singular characteristics of the property will give you an indication of opportunity, as well as a significant indication of risk. Each of these, of course get extrapolated out over at least of all 1/8th per year. As you get more refined in your estimate, probably over six months.

Capital charges include interest payments, principal payments and capital improvements. Interest payments and principal payments are not defined necessarily by a fixed interest mortgage with progressively lower interest and progressively higher principal. As you know today the interest payments may be on a regular adjustment basis. Principal payments may be on a sporadic quarterly payment or whatever and the result is that each of those have to be programmed from the contracts that are involved. Most purchase agreements today include some rather stylized principal payments at specific points in the future rather than a regular amortization of the debt. Indeed that may be one of the significant opportunities. The seller looking

down the road and seeing that he now has to raise so many dollars by 1991 may find it opportune to bailout now and let somebody else worry about what interest rates may be in 1991 after we come back to some economic reality. And the buyer, of course, has to anticipate that he may have to pay down the existing mortgage to come up with the appropriate amount and that may not be a bad thing at all. If you have a pension fund which has commitments to get so many dollars from his sponsors for let's say the next four or five years, the fact that there's a mortgage coming due in 91 is wonderful, it knows where it's going to go with its money-- it's going to pay off its mortgage and become an all equity deal, and that gives it a significant bargaining advantage over the private sector who might otherwise have to be concerned about refinancing the property now rather than later, or might be concerned about the fact that there's a very substantial prepayment penalty that he would have to discount against the price of the property, were he to get out from under that particular loan currently and so on. So again, the capital payments schedules, principles payments scheduled becomes a very interesting bargaining edge in one case or a seller's cross in another.

That brings us down to net cash from operations before taxes. The computation of the tax payment may have very little to do with any of the above. The net cash from

operations refers obviously to what's being generated by the business. The incremental contributions to cash available, one are going to be transfers from cash reserves, which may have anticipated some of the expenditures above, sinking funds set aside in one form or another and net increases in loan balances that may be possible as a result of either reaching certain occupancy levels of the building, perhaps negotiating a new schedule with the lender, it may even be settlements from tenants who wanted to buy their way out or buy successive favors in the project. For example, shopping centers--anchors on the shopping center are a Byerly's and a Target. The investor owns the middle, sandwiched, Target owns its own store, Byerly's his own store, the sandwich owns the land that's not covered by the pad or the building per se and the parking lot, and the parking ratio has been set by the Target lease which say thou shalt have six stalls per thousand. Target comes in and says to equity owner, we need 3,000 sq. ft. on the back side for new truck wells and so forth, we would like to pay you \$10 sq. ft. for the land. Owner says to Target, we'll give you the land, tell you what you do, reduce your parking ratio to 5 to 1 instead of 6 to 1 and the result of that is that they now have 8,000 sq. ft. pad to put more retail on the front end of the center on a free standing basis which in that case was worth somewhere in the neighborhood of \$500,000 more than the cost of

building the structure. Okay? In effect you now have created instant value of something like, \$900,000 in increase against the \$400,000 construction costs about \$50 a foot and the capitalized value was there and as a result the lender was only too happy to roll up his loan for another \$500,000 and so you have a net increase in the loan of \$100,000 more than it cost you and in effect what you've done is you've sold 3,000 feet of land on the back side for zero and created \$500,000 of value up front which isn't a bad deal, so you may be able to finance out on it plus that gives you net increase in the loan balance which feeds right into the cash, but it's not from operations obviously but from a one time transaction. A great deal of real estate is really advanced by one time transaction of a sale of a pad to a McDonalds on the front end. The provisions of some other access point for one of the tenants, etc.

Once we're net up to how much cash is available from operations obviously there are two elements which are going to reduce that that is available for distribution. One of course is going to be the taxes actually paid and those taxes are going to consist of one, federal taxes on operations, two, state taxes on operations, and occasionally assessments on the property. Disney for example in Buena Vista assesses all of the hotels which are all on 99 year leases from Disney and assesses them for participation in

their advertising program and so forth. The same is true on Maui, I don't think of the name of the hotel development on the west side of Maui, but it's a unique situation in which you have a subdivision for hotels, which the developers on the inland side created golf courses and other types of recreational amenities and then sold off hotel sites all along the ocean, to progressively bigger and more elaborate hotels and assesses the hotels for the ongoing development of recreational amenities and so forth. This is obviously an exception rather than the rule, but it's not unusual. Once you've computed the taxes, then the second element is what reserves are going to be retained in the enterprise before we have a distribution.

The reserves to be retained are critical entries as you will see again later when we start talking about partnership quite often the share of the general partner is computed not on distributable cash less taxes less reserves to be retained in the building, but generally on gross cash resources available, so that there's a significant discrimination between the general partner and where the limited partner's come in because the limited partners are going to share after whatever taxes have been assessed to the entity and after reserves have been set aside out of earnings to anticipate future redevelopment of the project. One of the things that is very important in negotiating

joint venture provisions is defining the base, base line, before and after taxes, before and after reserves, before and after capital income as opposed to operating income in which the managing partner and the investment partners and so forth, participate. And again, all on a cash basis obviously there really is no opportunity for disbursement and people that disburse without revenues quickly dig themselves into a hole. A good example of that, the Irvine Foundation which has a magnificent resource of Irvine California and the Irvine Ranch was required by law to distribute 5% of its net worth each year to charitable and _____ opportunity in order to retain, at that time, their tax exemption as a charity, and the McCarthy Foundation currently faces the same problem. Unfortunately most of the real estate was land which was not generating a 5% return after all of the other deductions and so forth were made and they were borrowing from the bank on a cumulative basis to make the 5% distribution to conform with the law, and of course each year you do the interest the costs the following year is higher and the income wasn't necessarily tracking with the incremental costs so eventually you get boxed into a corner in which you're going to have sell something in order to even the books again. And the McArthur Foundation has had some of the same problems, in terms of assets, incredibly wealthy, in terms

of cash available to meet the requirements of the internal revenue service not for taxes mind you but for maintaining their tax exemption. They're extremely cash shy.

Okay, the basic cash flow analysis then needs some kind of model which is capable of representing the dynamic changes in each of these items period by period. The investor is not interested in a week-by-week, month-by-month, kind of accounting. The investor is obviously much more interested in quarterly, half yearly and annual fiscal budget expectations with a model that's capable of calling the term. And the general magnitude of revenues, outlays, and the items there in. But none of the model are really interested in the specific dollar amount, they're much more interested in the ratio of various elements to analyze the project. Robins is heard to say that essentially you can judge the computer model not by the number of lines of output or cash flow but by the number of lines of ratio and analytical indexes which they provide, and I think there was recently an article in the Pension world that says the whole excitement of cash flow models that go lease by lease have passed and people were now looking for models that were analytical in character rather just simply simulating future operations.

Okay, what kind of ratios do we need, obviously we need two that are interrelated, we need ratios of risk and ratios

of return, and obviously those would be somehow interrelated as we believe or we probably shouldn't believe that. Yield is a function of risk.

Real Estate Club meeting Monday night at 7:00 in room 19. Learn about Manchester Place and the Convention Center. Other announcements.

We've been talking about the conclusions of projections about a property including a pro forma in order to arrive at some measure of yield and some measure of risk. Subdivided yield into retrospective viewpoints of the yield as reflected by how many dollars had been received or made out for a historical ownership period terminated of course by sale or disposition. And prospective yields of looking at the incremental yields of one more fiscal period as it related to the liquidating value of the asset at the end of the previous period and we were able to define that in several different measures. Which either you take, you have a very real accounting problem for the investor in terms of defining that which is income attributable to the real estate, and that which is attributable to other elements of the total combination. Not unlike appraisal, we need to be able to match revenues and time of receipt to a presumption as to historic or contributor of that. You have obviously land and building as a portion of your investment. You have personal property as a factor in that investment, and you

had intangible assets as a contributor towards that investment. Intangible assets being good will, perhaps a preferred access to a certain tenant; perhaps unusual management skills which provide greater efficiency or lesser efficiency, and how to report that on your balance sheet as to what was the return on the real estate investment, as opposed to what was the return on say a small business investment. You buy a hotel you come down to the bottom, the net income stream at that point, by the nature of the accounting, is an amalgam of returns partly from renting rooms, partly from selling meals, partly from running bars, partly from providing parking spaces, and partly simply because you can market individual instead of the state. Good example, Boca Raton Club in Florida is very exclusive, you can't use the facilities unless you are a guest one, at the hotel, two a member in the Boca Raton Club. And the Boca Raton Club you can become a member for \$2,000 a year, entitles you to nothing but paying the same bills that everybody else is paying to use any of the facilities. And they sell about a thousand of those a year, at a substantial piece of income. Is that real estate income or is it a business income? The ability to market an abstraction, a concept, a goodwill, a prestige factor. Why is that important? Because unless you make that distinction how do you measure the risk? The real estate will be there and be

able to rent hotel rooms on and on and on and on. What would it take to kill the prestige factor of a the Boca Raton Club in which for \$2,000 you are allowed on the premises to spend money like anybody else. That's a very fragile product. If you're looking at the total income of the Boca Raton Club would you apply the same capitalization or discount rate, the same risk ability, as you would to an industrial park in which the only commodity provided was concrete floor space with a ceiling 22 feet higher that was dry and insulated and you have a pretty fungible kind of commodity that was clearly real estate. There was no prestige, there were no purposes, tenant provided for everything and so forth.

In real estate we've gotten very sloppy about trying to attribute returns to the real estate as distinct from returns on the management ability, as distinct from returns perhaps on other related assets of personal property, the furnishings, the ability to merchandise the brand name of a club, etc. Our accounting systems don't allow us to do that very well. The appraiser would approach that problem and say OOPS let's back all the way up and say hey, we've valuing the land and buildings for tax purposes we really have to come down and say what's the rental value on the restaurant. We have a specialty shopping center that's really what we have in the first floor of a hotel. We have

high priced woman's and sporting goods, we have high priced low priced restaurants, we've got an ice cream shop, a pro shop, with a golf course and a tennis room, etc., etc. And you would assign rents to each of those spaces. And any revenue in excess of those rents would be small business revenues because of your marketing ability to sell T-shirts at twice the price that you have paid for them just off campus at the local sport shop and so forth. If we don't make that distinction how do we create comparisons of risk both risk internally to the project itself and comparative risk comparison. If we are going to believe in some of the malarkey about capital asset pricing that they contain various revenues and use a risk weighted discount rate to put this capital asset on some kind of parity with that capital asset. How do we do that? When our accounting systems are not capable of identifying that kind of income which is primarily managerial in character or primarily related to our personal property and related services and that which is truly related to space and land which is what real estate is all about. We have more and more merger of business management with big piece real estate and it's very hard to tell when the business of managing whatever goes on in real estate merges with the real estate return itself. That's my way of introducing, therefore, really some way of looking at risk.

Now what kind of risk do we pay for the real estate, and for which we might need ratios of one form or another. The first kind of risk is a revenue risk. Under revenue risk we have several different sources of business income, space income and land income. Traditionally the appraiser has always said we'll take the income approach, we'll take the market value of the land as though vacant and determine that say 8% is an appropriate return on fee simple on a number, etc., and therefore, if the land worth \$1 million. The first \$80,000 of net income should go to the land. Relatively sure thing. And indeed the premier blue chip investment is a ground lease, unsubordinated to the improvements that are above. Because at that point what's collateralizing your property is one, not only the asset which has been placed on it, but the mortgages that have been placed on the asset. If you've got a \$20 million office building on a piece of ground and somebody planted \$18 million on the building, the land is gotta be worth more than \$18 million or the guy that has the mortgage is going to keep making payments on the land just to keep control of his collateral. You may have a \$2 million piece of land collateralized by the \$18 million debt to the mortgage lender because it's unsubordinated, right? Therefore, the risk and the rate of return character of that component is quite different than step number two, which is the building

space involved and so forth. Again, one of the blind spots that we have is the presumption that the building will always be technically in tune with the technology of the time, and yet there probably in the last ten years has been no more rapid area of obsolescence than major commercial buildings.

Buildings built before 1973 with the steps, with windows that do not have insulating glass, with roofs that have low U factor so the heats leaking out, with fire safety systems that wouldn't meet today's codes but are grandfathered in. With more layouts that do really meet the trend away from large cargo kinds of desks arrays; but what's needed to fit the small entrepreneur is 1500 sq. ft. or 2,000 sq. ft. and everybody wants a window. This thing about the shape of the building. A building with 50,000 sq. ft. per floor built in a perfect square doesn't have very many tenants that can handle that space and make reasonable use. Saturday I'm going up to look at a shopping center in Fond du Lac that was built in a day in which the spaces were like 220 ft. deep, and the assessor says well, lady's shop gets so many dollars a square foot and he multiplies that times the whole sq. ft. But in fact the Lerner's store up there which is 6,000 sq. ft. presently if it were leased today would be about 3,500 sq. ft. Inventory policies have changed, marketing strategies have changed, and ability to

deliver on order from a limited stock therefore has been greatly accelerated. Tremendous built in obsolescence so that obsolescence factor lags significantly the income factor, but nevertheless it's really there. Think of the little strip centers that have 12,000 sq. ft. supermarkets and they're playing out to the end of the 20 year lease, but there aren't going to be many 12,000 sq. ft. supermarkets. You can see in Milwaukee over on the west corridor, Kohls just went in with 50,000 sq. ft. on the one end National Avenue and Sentry is coming in with a 60,000 sq. ft. food store on the other, what's happening to the rest of them? They're being converted to engineering and architectural offices is what is happened. Think about the inherent obsolescence in a shopping center where the land parcel was originally configured to anticipate a 12,000 sq. ft. store with X number of parking places. And that's not the way we sell groceries anymore. We really have to look at the land and feel great. The land still is getting its 8 percent return. But we need the total net income from the project. The building may already be useless, it just doesn't know it yet.

But now the third element will be what we'll call business income. Now while the land may be valuable and the building is worth zilch - zero, the business income may be very significant. I, as the general partner, otta get a

property manager fee, I sell it the insurance policy on it and therefore, get a commission on the fire and liability coverages on it. I get leasing commissions as I may go through a rollover tenant, not based on the net productivity of that tenant, but based on the gross. Property managers don't get compensated on net they get compensated on gross. Terrific, the business income may be well worth while, and simply if you look at the nature of a property management firm, or an insurance agency firm or a leasing firm, they're very definitely fixed costs variable revenue enterprise. And the base cost--they got a secretary, and a telephone and an office space, and at least one guy doing the stuff and so forth, but he can manage it, the infinite capacity and growth and if he moves over that threshold of that basic six months of operation, wow that's a money machine. And you see many commingled fund people looking at their investment not so much from the diversification advantage of the ultimate investor whose saying gee I'll have to protect myself against regional economics and so forth and so on and so on, he's saying hey, I already got a property management firm in Louisville and it's just barely makes breaking even and so forth, but if I get another building in Louisville, that same guy and the same secretary can take care of that project too and now presto the business income is a very significant motivator for that acquisition's guy to go out

and buy that building. And in fact, the business income may have a much lower risk characteristic to it than say the building and building rent is fickle. Win, lose or draw you're going to have insurance, win, lose or draw you're going to pay leasing commission because you've gotta keep the building filled some how. But typically we don't look at a real estate investment that way, but that is the way we should look at it before we start discovery of risk. When we talk about a prospective rate of return or a retrospective rate of return we have to identify which components are included in that return. Have we boiled it down to land and buildings, or do we have land and building and enterprise. Otherwise capital asset pricing model and all the derivatives thereof, the works. We're not pricing capital assets anymore, we're pricing a business called management and leasing and we're pricing land which is something else again and so on.

The second major problem with risk and real estate, once we get beyond the revenue risk which I've talked about to this point, is obviously the financial risk. The adequacy of net income and the reliability of net income could meet our debt service commitment, financial risk. We talk about debt cover ratios--there is a ratio measuring financial risks. We talk about cash break even points which really is what a combination of the revenue risk and the

financial risk, isn't it? We're saying here are all of our costs for operations plus our debt service and interest and principle as a function of gross revenue, right? Since the financial risk is really first a function of the business risk or revenue risk of the enterprise, the cash break even base point makes much more sense than talking about the interrelationship.

The third risk for the investor is interest risk. It can be very painful. We have a building down in Tampa which is a nice sweetheart of a new office building about which is about 50,000 sq. ft. and a couple of years ago we very adjointly renegotiated the mortgage to a 12% mortgage--terrific, that was a good rate then, everybody else thinks 13.5% we got 12%. The problem is we got locked in for about 10 years. If you sold the building today you would have to pay the difference on approximately five years remaining to go on the mortgage between the 12% rate and about the 11% maybe 10 3/4% going in to get another 10 year mortgage. Now we're talking about a \$450,000 deduction on the purchase price. Anybody going in that's what they're going to take great, this baby's worth \$8 million less \$450,000 for the interest risk. You took the interest risk, you lost it. There's \$450,000 right off the value of the property because you're locked in, no prepayment penalties, etc. allowed unless you want to pay the equivalent difference between

that and current Treasury, etc., etc. Interest Risk. Where does that show in the discount rate?

Next element to the interest rate risk is the monetary risk or probably better stated as purchasing power risk. The dollars that I had going in, whether they represent a purchasing power relative to the dollars that I'm taking out. Subcategory of that which is extremely dangerous, is the exchange rate. Japanese investors that came in two years ago, taking a 40% beating on their assets, just on the exchange rate. The exchange rate again has dropped 40%. Then in today's international market we're not only concerned with what's happening to the currency in which we're working but we're interested obviously in the currency in which we stated and we want to repatriate our earnings. More investors coming in today are usually coming in not with a single exchange rate but are coming through as many as three to five different currencies. Where they can arbitrage and win on some and lose on some, so a Japanese investor might put in 25% of his investment in yen, 25% in Marks, 25% in Swiss dollars, and 25% in something else and hope that the ups and downs of those relative to the dollar will soften the total risk of the purchasing power of their initial investment. Again an ending cap rate doesn't say anything about that, for that matter where the capital asset pricing model does it say anything about that. You could

make a very good argument, a simple minded view of course of life is that gee they only get 2.5% in Japan on a savings treasury from the Japanese government and you get 8% on a US Treasury, therefore why wouldn't they invest in the US? Well, I'll tell you why they wouldn't invest is this 5.5% gap really represents their international measure of risk in the US buck, in terms of the purchasing power its exchange rates relative to the rest of the world in terms of the ultimate stability of that borrowed capital over a long period of time. They don't expect the purchasing power of the yen to change very much, so 2.5% is the real rate of return, 5.5% on a US Treasury over and above that is your risk premium. For all the things likely to go wrong with US dollars over the term of the investment and as a result Japanese Treasury and American Treasuries are priced the same. Purchasing power risk. Therefore, you really need to know what kind of dollars went into the investment. Does my discount rate include a loading not hopefully. Recognizes that it's a possibility.

Once we get past the interest rates and the purchasing power risk today we have another risk, that of course is the tax risk. Will the rules change as the game progresses? And the answer's yes. We just proved that between 1986 and 87. We're still proving that, Mark showed me today an article relative to taxation of M_____ partnerships what

are called publicly traded partnerships and retroactive to 86 and 87 Uncle Sam had said OOPS wait a minute those are not conduits those are like corporations and will be taxed double tax basis and depending who will have the rules out in a few days and then we'll figure what you owe us from 86 and 87 then. A real estate investment trust for example has very specific criteria that it must meet in order to maintain its character as a tax conduit. In the old days if it missed one of those and that was discovered in an audit three years later, it blew its cover all the way back to the point at which the mistake was made. Today it has, I believe, one quarter, three months to correct for whatever error and it doesn't take much. Says you gotta pay out 95% of your taxable income to be a real estate trust, right? What if they determine that your depreciation taken in a given year was too great, that you used the wrong formulas, therefore your taxable income was more than it appeared to be to you when you did it initially and therefore, your pay out was only 93.5% and you blew it, you're not a real estate investment trust, unless you go back and correct that. Out of the generosity of the tax law saying I'll give you 90 days to correct that, tax risk. Very significant problem which generally is retroactive and generally it provides for no cure other than paying the incremental tax, which may be very disruptive to your whole organizational payment thing.

And finally a broader category of tax risk or maybe tax risk is a subcategory of this risk, I don't know, is entitlement risk. The right to use your property for some specific purpose. Well, the hot topic for land use control for those of you who are in 852, is there a point at which a developer is guaranteed that the building that was on the property when he bought it is a vested interest. By and large it's not. By and large he bought the property assuming that it was going to be zoned so and so let's say for a density of 18 apartments per unit and now along comes the master plan that says gee, we'd much rather have a green way there, and so forth, and this looks like 6 units per acre density type land and there's no reason why they can't down zone it and there's no taking. Or they just simply decide a little investor, that gee, it's certainly in the public interest that you have sprinklers, and that you have smoke alarms, and that you have locks and bolts on all the windows and doors, and so forth and so on, and you've got a project then which is now going to cost you \$500 a unit and you got 100 units and you're out \$50,000, but I'm sorry baby, it's a good thing to do so we did it. You may have five years to meet those norms or may not reach at all until you try to sell them, at which point you're non-conforming and there's a lien on your title and you don't have marketable title. But it's a very real entitlement risk. If the _____ says

it's non conforming and if you don't find a new tenant for it in a year, you'll want the grandfather status as it reverts back to whatever the grand plan calls for and there's no compensation for that. Entitlement risk. The rules change. Economic police power there is virtually no compensation for a change in the rules. Very high real risk of equity investment.

Now, given all of those elements, how do you construct the discount rate that reflects that? What ratios do we want to look at that reflect that? What ratios do we want to look at? Obviously each project has its more or less risk in each of these categories. And the analyst is going to have to look at the project with those inherent characteristics and develop ratio which first of all, provides a comparative measure of risk. The presumption is the cash break even point goes higher, the property is somewhat more vulnerable to changing the rent rates, occupancy levels and so forth. If we assume that the density of that particular project is approaching the maximum limit on that particular site, wouldn't take very much down zoning to suddenly become nonconforming. A good example is the shopping center which you appraised in Middleton. The parking was 150 as I recall, the minimum required was like 142. There had already been a taking off the corner of the property which cost them about 8 units but

there's another little provision that says if you have a restaurant, it's not one in three hundred, one parking stall for 300 square feet, there's one parking stall for 99 sq. ft. or per 99 sq. ft. or something like that. So you could conceivably put in a restaurant at the same time that you were going in for a renovating remodeling permit and all of a sudden find out you were nonconforming in terms of the required public ratio--parking ratio for the property. It doesn't take very much to trigger that, that element of nonconforming. Raulac suggests that at least one way to be sensitive to the varying degrees of that is to go about building a discount rate like a buildup rate of old. Remember the old stylized appraisals of the late 30's and early 40's talk about build up rates. And he said okay, long term 20 year Treasury bond which parallels in terms of the term of the bond, the projection series of real estate that Treasury bond is yielding 5.5% and then we think the developer or owner of the property ought to get let's say a half percent for giving up liquidity on the real estate and adding a one percent for the incremental risk that's involved in a real estate bond and another one percent for the management hassle that's involved in a live asset rather than one you can stick in your safe deposit box and all of that adds up to whatever it might be say 7.5% and you have a build up rate. It was making conscious recognition,

explicit recognition, of some of the concerns of the investor at that time. More experience tells us perhaps that we're looking at the wrong problems. Liquidity really is the problem for a good piece of real estate today.

You can have a high silhouette attractive piece of property and there are more than enough buyers out there and many of them could close a deal in 30 days if you wanted to sell your 400,000 sq. ft. office building on Michigan Avenue in downtown Chicago, there is no real liquidity problem there at all. But there may be no real management problem there at all either. In fact you may have to be more clever in managing stocks and bonds but its insider trading than you have to worry about in real estate. So what are the risks we should be loading. As Roulac suggests we would start out with a real rate of return and the economists will debate considerably as to what the real rate is. But traditionally it's been somewhere between 2.5% and 4.5%, you can pick one. Then to that you really ought to begin to add one, something for the marketing or business risks of the property. We're in an overbuilt market and your tenants may leak away as their leases come due and so forth, you may want to add 2% or 3%. If its monopolistic, elderly housing, Section 8, and years to run on a subsidy and so forth, you're reasonably assured of your revenue line. Then you want to look at the financial risk, how much of a loading do

I want to put on it for my ability and the adequacy and the reliability of my income relative to my debt service? Then you may want to load it with a change in purchasing power--that's quite common today. Question--How can you peg a number for financial risk and real rate of return, and competition. I don't understand how you arrive at a number? Chief--What is the spread and yield between a AA and BAA? A. BAA bond is one in which there is significant possibility of lost principle, right? Where the top grade bond presumably has almost no probability of lost principal, right? How many basis points can that be? Not a perfect measure obviously, but it's certainly one measure of the way investors might look at the possibility of default. We try to find analogy in the other financial markets which do require it. Another way of looking at it would be saying gee, what's the difference between a mortgage rate and a bond rate of the same maturity. Our next problem of course is what kind of loading do we want for the purchasing power risk? One might be the index for currency de-valuation from the federal reserve board, what's the past five years experience on that or the last three years experience? How many basis points should have been added in to cover that. The same would be true of interest rate risk. Where are we on the curve of interest? Do we think we're at the very bottom of the curve because we are at 7.5% mortgage and its

got another 20 years to run and so forth, why we probably have no loading for interest rate risk at all because our view of the world is such that interest rates are not going to fall below 7.5% and what's more maybe we're not locked into that. On the other hand you were singing along there with a 14% rate and we're locked in because at the time you did the deal that was the only deal we could get and they wouldn't give us repayment privileges and so forth, there's a high probability that we're going to have our difficulties with that. For example, there are a number of real estate investment trusts out there such as [UK2, or EGK] in which most of the financing was done with a zero coupon bond otherwise the current cash on cash yield would not have been acceptable. When you look at that bond it's yielding close to 13% currently cash-on-cash, before you adjust for the fact that you're really going to have a sinking fund to anticipate that zero coupon bond. You set up a sinking fund which will reduce that zero coupon bond by the amount of compound interest on its term that will occur between that date and the maturity date on the zero coupon bond, now you're setting aside about 2.5%, 2.75% a year, its allowing you 13% yield and subtract 2.75% you've really got a 10.25% against the interest rate risk but the property won't appreciate to cover the compounding base of the zero coupon

bond, correct? Classic interest rate risk in the investment, factoring that out.

The entitlement risk is extremely hard to obviously evaluate. It generally occurs on a property where you have physical anomalies which reflect obsolescence, or obsolete technology or density which are inconsistent with current standards. Nobody's quite sure when they should take a "pass" on the building. The public health people have been kind of craw fishing on it. How much asbestos is too much asbestos? In most cases if you were to take a reading on ambient asbestos you would find more in the street outside the building than inside the building. Indeed much of the ambient asbestos inside the building may have been pulled in by the air conditioning because right in front of the building is a stop light at the end of a long run and people are really applying the brakes and most of the brakes today have asbestos in them. So as a result the automobile outside is distributing all of the asbestos which gets picked up in the HVAC and now you got ambient asbestos in the building which under some standards would say gee, we ought to tear the building apart to find out where that's coming from and all you've really got to do is close the front door and turn the HVAC ducts around. Okay. Those kinds of problems we really don't know where they're going to come home to roost.

Energy problem. We certainly have an energy standard for new buildings, when will we have an energy standard for old buildings? And how much would it cost to bring the building up to code? And it may be one of those optional things. GSA doesn't say that you have to take the asbestos out of your building. What they say is they will not lease in any building that contains asbestos. If 50% of your building is GSA and you have asbestos, you obviously have a releasing problem coming down the pike relatively quickly. How do you finesse your way out of that babe. I know one project in Washington DC in which there's asbestos tile on the floor which was a government required spec at the time they moved in. Their lease comes up for renewal in three years, management is quietly going through picking up the asbestos tile and carpeting out of the goodness of their heart. So that they don't wave the flag and say "YuHoo, we have asbestos on the floor. They are just quietly working their way through the problem. All of those represented entitlement risk. What's a proper loading for that is anybody's guess. But obviously a function of what (end of side one) you know about the building, what you know about the property.

All of these things then begin to build a discount rate, which at least for the decision maker is a useful way of evaluating alternative investments, and which ones he

should buy. It does nothing of course for that other function that we would like to have out of net present value in terms of how are we doing relative to somebody else's project? Did we pay more or less than someone else would have paid for the property? Is in fact the discount rate in the market so efficient that different rates paid for different buildings truly reflect the loading that people are putting over and above their real costs or real return on land? That's where real estate hasn't solved the puzzle much at all. It has no real effective way of bridging its performance or its relative performance. Not only does the real estate, but many other forms of investment. How are we doing relative to bonds, how are we doing relative to stocks, what's the risk payoff matrix that makes the capital asset pricing model presumably a logical, analytic tool for selecting investments. Up to this point, those that investment in real estate, have simply reduced their risk to the degree of variance in the net income from the property. How volatile is the annual or six month, or whatever fiscal period they want to choose, net income from the property, net distributable income from the property. On that basis they argue that real estate is relatively more stable than stocks. Obviously, not quite as stable as bonds which by their very nature are set on a coupon basis. But they 're a

little hesitant to examine what's going on above the net income line to figure out what's causing the variance.

One thing we know for sure is that risk in real estate has nothing to do with property types. The premise that hotels are riskier than apartments or industrial buildings are safer than anything, are generalizations which simply don't hold up. The systematic risks are much less significant to real estate than are the non-systematic risks. The risks peculiar to a particular property. Believe it or not, and this is not meant to be a derogatory statement at all, Prudential has no idea of what diversification was even though they had now invested \$2 billion in PRISA I and we're counting it as a diversified fund. The entire asset management area still doesn't know what diversification is for risk management. There was a time when the premise said gee if I bought a mix of properties that were industrial, apartments, office, and hotel properties, and I scattered them all over the landscape geographically, this naive sense of diversification would somehow stabilize my returns. Yet the initial studies by Mike Miles and others indicated, you could have gotten as much diversification by buying five industrial buildings of different size in Chicago. It was much more important to have different markets for the same type of building than it was to have different buildings in

different markets. So they're starting over, they're saying gee, maybe risk is inherent in economic fate and dependency of different communities on specific SIC codes of employment and so on and that if we had thought about that in the past we would have realized that the heavy dependency of Houston on SIC codes related to energy was not as well diversified base then we wouldn't do very well there. Then we should have stayed in Chicago where the SIC codes were much more diverse, and employment was is much more evenly distributed over many categories of endeavor. We're just now beginning to say hey, maybe not all of you wanted to be diversified by SIC code, but I really want to be diversified by tenant. If I have five shopping center all by Dick Jacobs or five Centers by General Roe and 85% of the tenants in each of those shopping centers are the same national chain, am I diversified? Grants went out of business, they went out of business all over at one time. Maybe diversification should be by tenant type and owner. It certainly is easier to put together a shopping center if I have a codery of tenants who follow me around the landscape and go into everything that I do, but on the other hand maybe that suggests that as an investor I don't want to own 17 general store shopping centers. Because as a matter of fact even though I have all of those different shopping centers 85% of my revenue may be dependent on 60 firms. And retailing firms haven't been

going for their longevity. The department stores seem to be going out of business quickly. I'll tell you one other monetary risk story, it's a true story showing how subtle it can go - I'll give you two of them right away. In El Paso, Texas the RREEF Fund (Rossenberg Real Estate Equity Fund) bought a shopping center which was the greatest thing since sliced bread, it was doing just great and the revenue per sq. ft. was way up it cost very little to build down there, the retail help doesn't cost very much. The profitability was marvelous, only one small technical problem, the Mexican economy went to hell in a basket and the value of a peso relative to a dollar meant that nobody that lived in Mexico could come across the river and shop there anymore. 50% of their trade, gone, from the exchange rate. So they went into bankruptcy. And yet they had the greatest thing since sliced bread. Great trade area, good looking shopping center, all the National tenants, they never even looked at the implicit assumption that if 50% of your businesses is on either side of the national border, that something could happen to the ability to move across that National border. Gone. Second one, a happier ending. In the 1920's it was common to index a lease against changes in dollar values against gold. We were on the gold standard and everybody expected the dollar to devalue and therefore most leases had what was called a gold clause in the lease. And the

gold clause said that at any time the landlord could require payment of the rent in gold rather than in dollars in an amount equal to 25 3/8th grain of gold per dollar of rent due. When we went off the gold standard in 1930 umtiumpt, obviously many of the landlords pursued that choice and first as a government dictum and then as a congressional legislation they ruled impossibility of performance because Americans were no longer permitted to hold gold for commercial purposes and therefore the clause was no longer operational and congress later passed legislation to that effect. Then in 1966 as inflation began to take hold, Congress says gee, if they want to index the gold that's not such a bad idea. So he abolished the previous legislation and said if you want a gold clause you can have one but, to become operational in an old lease you would have to in effect confirm that. What's called an ovation. Reactivate that clause. So far so good? Now a family owned the land under Frederick's department store in Seattle and made the lease for 99 years back in the mid-20s and ultimately Fredericks sold to Batta the British American Tobacco US retail giant. And in the process of taking over the properties they just automatically reaffirmed the existing leases including the ground lease under the store. By this time the third generation heirs to the family that owns it the hot shot MBA students at Seattle, it has always ground

them down that they have this fixed rent which was in 1900 \$20 was wonderful but today was not keeping him into the styles of which he would like to be accustomed. And he sues and he says "when you confirmed the lease, and Fredericks went off and Battus came on, that is an ovation, that is a new contract." And Battus' initial attitude was yeh, so what? The director of marketing says, "I'll tell you so what, 1966 says that if there's a gold clause there and an ovation it's operational again, and your rent at some ridiculous number like \$26,000 a year, in fact should be 46 times higher given the current price of gold, annually. And that has been true since you converted the lease, so you owe us about \$6.5 million for things to be current. And Battus lost. The gold bar once confirmed, is operational again. Very interesting currency problem--purchasing power of the dollar. Would you write a lease today in which you index it to gold? Obviously a couple of years ago that looked like a real bright idea, gold kind of went down but it sure isn't the \$35 an ounce it was when I was a boy. You could have done very well by buying coins in gold. In fact I wish I had done that instead of going into the building business I think. But, nevertheless, those kinds of changing environmental situations create some very real risk problems relative to real estate.

Now let's go back and look at business risk problems or market risk problems a little further. Real estate is relatively unique to the degree or extent that most contractual negotiations are concerned with the risk allocation between the partners. Part of that of course is because the time period, the duration of a real estate agreement is so much longer than the typical agreement. Most real estate agreements are in a continual state of being executory contracts--things to do in the future sort of thing before they're complete, as opposed to other transactions in commerce which are kind of open and shut. I bought a car, I owned it for five years, I sold it, bang, relatively short term kind of deal in an interrelationship between a car buyer and a car seller is rather short. Real Estate obviously relatively long term. If risk is the variance, between your expectations and your realizations, between pro forma budgets that you set out for the property and the actual income achieved - certainly the modern American lease does a beautiful job of stabilizing the expected performance for the investor. He has laid off virtually all of the variable costs on the tenant. [Problem with the tape - goes blank] If he has done his job in terms of selection of tenants and the credit capacity of the tenant, then the variable risk for the owner, the landlord, the investor, isn't the traditional business risk at all, it

is in fact the legal risk of being able to enforce the contract. Largely a legal risk partly a credit risk obviously in terms of, are there going to be funds to support the debt? That's a somewhat different type of marketing risk - true, once we go into hotels in which every night is a new deal and people decide not to come because they heard the report that everyone got Legionnaire's disease last week, you have a real marketing/business risk. Remember talking about these office buildings or industrial buildings with 5, 10 or 20 year leases on the building. That's not the same kind of marketing risk in which there's a continual instability because of the turnover, it really is the enforceability. That enforceability is another kind of entitlement - there's an interrelationship there.

The bankruptcy laws changed and said - heh - you can't have a clause in your lease that says if a tenant is bankrupt you can throw him out on his ears. In fact, the fact that he has that lease may be one of the principal assets of the bankrupt and that should be protected for the benefit of all his creditors and therefore, one can't throw the tenant out and until the court says one can throw the tenant out and in the meantime the rents which are due following the declaration of bankruptcy will have a preferred claim on the asset, etc. but the fact that he's leaking on the ropes isn't sufficient grounds to throw him

out of your shopping center or your office building even if he's giving the place a bad name. Burden of proof is on you to show a hardship, uncollectability, etc. etc., etc., change in the rules, and we see that all the time.

Is the public mall of a shopping center truly a public mall? Or can you argue that the mime, the dancers, and people of Central America and people buying ice cream cones are not entitled to wander down the way and eat it. Rouse went to court, said you can only eat an ice cream cone in an ice cream shop - carpeting is mine. The ice cream shop says heh, that's unfair because nobody will wander in and wander out - I haven't rented enough space for them to have a place to sit down, I just have enough space for them to look through the glass and pick out which flavor they want. Enforceability. Now there's a typical context to that, really is a large part of business risk today. We've gotten very sophisticated in identifying the potential variance in our revenues and our expenses which with our traditional definition of risk, and we allocate those and we share those in some reasonable way, maybe unreasonable way depending how much market power you have. But then the next thing of course is to make those arrangements enforceable, some of them are not enforceable because they're in violations of fair trade if it comes right down to it. Those of you who had Emmanuel Helpert last year, one of the common clauses in

a shopping center lease is that the tenant must remain in operation and keep his store fully stocked, etc., etc., etc. Normal operations guaranteed - totally unenforceable now in the courts. If they want to shut their store or pay their rent there's nothing that can be done. Question: Who won the ice cream thing with Rouse? Chief: Rouse won the legal victory that if you sold an ice cream cone they had to eat it on the premises, but the human cry was such that from a PR standpoint he had to capitulate and say, if the kid wants to eat the ice cream cone wandering down the mall, the only way to control that is to not have an ice cream parlor in the mall. So quite often you can win the legal point and lose the practical battle which is what happened in that case.

OK. Now having discussed the kind of risk that we characterize with an investment, we've looked at the possibility of having a loading on our discount rate for each of those risks, what is left of the real estate investor of course is a realistic way of measuring how many basis points he should add to the real estate and the devaluation or inflation rate to cover these other factors. And I doubt if you'll find very much literature on that. So these are the kinds of things they're talking about in portfolio management today and talking about in terms of the goal to acquire assets, it's a whole new subject area for

real estate. We've now convinced everyone that discount rate is the way to go and we really want to talk about distributable cash - we have two problems, distributable cash from what? And what does the discount rate contain? Is it simply a discount rate that everybody in the market says, today's pension funds are buying at a threshold yield of 13%. Where does 13% come from? What does it contain? How much real return? How much devaluation return? How much as a risk premium for the different risk attributes of equity positions? And is that relevant to that kind of real estate, or is anything you put in a pension portfolio called a 13%, there's a leading suspension right now, everybody calls it 13%, but nobody knows why except Blake Eagle said so at the last CREA meeting - it moves from an offhand remark to a consensus and to be a fiduciary all you have to do is stand in the middle of a consensus and you can do not wrong. Your honor, call me guilty of negligence but all the idiots around me made the same mistake, as long as you're with the majority of idiots, you're safe as a fiduciary.

...to financing the property and so I have taken it upon myself to subdivide the files into four groups so if you will make a note this relates to the first letter of your last name. And A through C will cover option one. D through K will cover option two. L through Q cover option three. All those that do not fall into one of those three

categories will be option four. Not all of the options may in fact meet the specifications of Mr. Diller and Shaker and therefore if you fail to _____ I guess the question basically is how close did you come but you may not do that. From the standpoint of the development committee, why they should do what they do and over see as they do. (Talking about homework and assignment) Three to four pages would be more than sufficient, the computer program can be Mr. Cap or Project and you can build your own Lotus system and work it out. And other comments, inputs. Due on Feb. 22 I will hopefully wind up tax matters and hand out the Clifford case and expect to receive your Diller and Shaker so make a note of that the 22nd and the 24th are reversed.

One subject we haven't really talked about is the options available to the individual investors and probably for your own safety you might want to set up some sort of matrix which matches the options against certain alternative attributes a private investor might want to have. Obviously the first option is sole provider. The second option would be a general partnership, a third option a limited partnership unit. A fourth option would be a joint venture, but when we say joint venture as an individual we're essentially talking about tenants in common, as distinct from general partnership for example, or we're talking about a ground lease of some form or master lease. A ground lease

technically being a vacant site which someone else is going to develop and which the individual then receives rent and possibly some participation in the revenues and the improvement. A master lease would suggest an individual property perhaps improved in another time say 30-40 years ago and the family doesn't have the money to improve it, reposition it, market it, manage it and so forth, so they master lease it off to a developer who as 30,40,50 years of ownership of the structure and can invest and improve the property with the individual still getting a rent with some kind of kicker related to the index and some small participation, but generally the master lessor says hey, I'm creating the value for it, I'm providing the budget for improvements and so forth, the old American way is them that takes the risk takes the profit and therefore aside from a possible index for devaluation of currency you're not going to participate on the upside, since you didn't do anything for my upside other than stay out of the way. But those are the two kinds of joint ventures which an individual can do that are small scale enough that they can get into it as distinct from some major project that the heavy player might be into. Next you can invest in a real estate investment trust. You can invest in a SubChapter S Corporation. Notice all of these up to this point are single conduit entities. And finally of course you can go into a double

tax entity which essentially is a small family owned corporation. We are ruling out for the moment other types of securitization that might involve participation in a CMO or something of that sort, we're suggesting those are more financial instruments than they are real estate per se and we're also ruling out for the moment an investment in a publicly traded stock although obviously would be an alternative you can go and invest in Rouse or Northern Pacific or Disney for that matter which is a fairly good sized real estate operation. But as far as I'm concerned for the moment we're treating that as a stock market play as opposed to an ownership of real estate play per se. Somewhat arbitrary but nevertheless in terms of format.

Now what are the attributes. The first attribute is scale. I've only got \$10,000, what can I do with \$10,000? It's a scale, how big a unit, how big a chip do I have to play and how much am I wise to put into a single entity. The second thing is control. The third is intensity of management, that should be distinct from control. I might go into a master limited partnership in which what the Lessee was going to do with it is going to be very carefully spelled out and let's say the family doesn't want the exterior changed because of its historical significance, etc., and they want this and they want that and that could be built into the agreement before hand and there's some

degree of control as opposed to an REIT in which you put your money in and you sit down and you shut up. In a limited partnership you've got three options. You can vote with the rest of the limited partners to displace the general partner for malfeasance, you can vote when you gotta refinance, you can vote when you get it dissolved, and otherwise you shut up because if you do anything more than that you are now a general partner at the voting level. I think you ought to distinguish between the degree of control in terms of the over all strategy and the intensity of ongoing operational management. The master lease provides no intensity of, you might as well go to Florida and wait for the check. Once we get by those elements obviously we're concerned with liability. Under liability I would put two items, number one obviously is liability on debt. Number two and perhaps much more significant than the decision process even though it adds a lower probability of coming home to roost, its liability for third party torts. Okay, once we get by those items the next may be simply if you want to look at it from the stand point of risk. The variance in our financial development relative to our financial plan. And the last major item is the ease of transfer by gift or by inheritance. The ease of transfer by gift or by inheritance.

Owning a building outright is a sole proprietorship, that means you have an appraisal problem, immediately you have the possible gap in consistent management of the property, you certainly have a problem with the administrator that you have to bring in a provision in your will that he's permitted to retain ownership and operate the real estate and do whatever is necessary without concurring further liability to the estate if it doesn't go well and so forth. With an REIT share, nice clean valuation on the date at which you died and you can look it up in the paper. And if you're working through off shore trust or something of that sort there's no estate tax, no transfer tax on it to get at all and so on. One other element that you would add to that if you were probably, although not entirely many _____ or US citizen as well. You might intake as another attribute, degree of anonymity. If you're working for Coldwell Banker and Coldwell Banker says that you cannot own real estate because there will be a conflict of interest potentially between you as an owner/operator of property and our clientele in the mortgage banking and the brokerage business and you're not going to own property that's on the record, etc., etc., you're going to have to find a way to hold real estate with anonymity. And if you're coming in from overseas and you brought your money in cash and your government says you can't, from foreign countries say you

can't take the money out. The U.S. government has a 30% tax on withholding if you sell the property or whatever you may want to A.) Conceal who you are from your government and B.) Conceal the fact you're foreign from the American government. Degree in anonymity.

Now you can mix and match all of those attributes against each of those property holding types and an individual investor can begin to put together his strategy if you will, how they are going to go about investing in a real estate asset, a hard asset. I just finished a good book called the Storming of the Magic Kingdom which had to do with the attempt to raid the Disney corporation and break it up following Walt Disney's death by a guy Sol Steinberg out of New York. And its a good philosophical as well as a high drama discussion of raiding and exposing cons and his methods and so forth, but what's interesting is one of the players didn't really believe in the movie business he said was a hard asset man and in movies he said all the assets walked off the lot at 5:00 in the afternoon, he didn't invest in movies. He was a hard asset man. So I guess what we're talking about in real estate today in this course is higher asset.

Any questions up to that point? Question--where do tax considerations come in in buying the attributes for each ownership? Chief--Well, there a little or no tax to be had

other than the estate tax. However you structure it there may be minor variations between the corporate and the individual tax rate, but as soon as you decide to go the individual route rather than the corporate route, you belong to anonymity for one thing and complicated your estate problems and so forth. One suspects that if we ever get an honest President, which of course is remote, the distinction between those two tax rates will differ and what's more the 34 versus 28% tax rate really isn't a true statement of the differential because the individual in a corporation can vary so many other things. For example, 25% of your net income can go in a profit sharing plan which isn't taxed at all. We can invest in more real estate. You can even have your own trustee or have your own pension fund, and so at that point now you're really stating the rate of the Corp. 25% less than that so subtract another 8% and that is a whole lot lower than the individual rate. In addition you can buy your medical insurance and rent a car and a variety of other things that you can do, and tax ratio really isn't very significant. It's the base line that the rate applied to and how much you can monkey with that that really counts. But otherwise you can put tax rate in the list the tax game has pretty well fallen out except for the value in the proposition. You get a stepped up basis and pay no capital gains tax and start the depreciation game all over again.

You can raise grandchildren who are able to exploit that, terrific.

Okay, now let's talk a little bit about the tax laws. Given the format by which you choose to invest, obviously you want to structure it in such a way that one, you acquire it with an audit trail that supports your basic strategy. When we talk about planning your anticipated tax strategy in the acquisition process. While you operate the property you also have certain elections to make. Revenue, what's expenses, what's capitalized, what you postpone. And then once it becomes time to dispose of the property, again there are obviously disposition ploys which can mitigate to some degree the overall tax status. Many of those gains obviously have changed significantly with the new tax law and I have handed out two of those that you can look at, the hierarchy of critical decisions in that process of acquisition, operation and disposition. One basic element and why its certainly relevant in this course that we're discussing what the individual can do is the tax law has completely flipped its perspective and while it was perhaps particularly favorable to the well to do and the very rich and the very high income tax bracket, today's laws very definitely is biased in terms of the small investor--the middle class investor that presumably votes for Reagan and therefore, again the _____. The application here on

part four is what I've done is taken out something of some of my notes that I've prepared for something else and think small. The real estate investor with \$125,000 of active income or less. The double taxation of small corporations isn't too serious, but there's a 15% tax rate on the first \$75,000 of small corporate income. That is not a bad thing as an individual that can create a corporate holding vehicle for his duplexes and buy another rental property and with the joint handling of his pension fund, his lease car and a few other things, that can bring that net income line down below \$75,000.

Risk rules require the general partnership with no more than 10 partners so a large equity investor generally prefer the general partnership form and looks like the new tax laws that is going through will penalize the master limited partnership and some of the larger limited partnerships even further and the real estate with a family business orientation may still take a relatively desirable tax shelter position and so the basic law is certainly orientated to the smaller investor like you, for example.

Okay, the outline in here which was done by our accountants here in Madison for me at one point, essentially says there are three buckets worth of income under the new tax law, one which we will call passive activity, which has to do with all rental in real estate, limited partnership

and all businesses where the tax payer does not materially participate. And materially participate is narrowly defined so it comes with a good many of them--regular, continuous and substantial involvement. A general partner by assumption has regular, continuous and substantial involvement, hence the goal of the general partnership and for a certain thing. When we talk about real estate only dealers can be determined to materially participate and therefore at one time it was anathema to be a dealer, today that may be a very useful device if you have more income in the passive category than otherwise. The general rule is that net losses from passive activity are not allowed as a reduction to other income and the exception of course is the small income individual active real estate owners are allowed up to \$25,000 of active rental property losses, and they have to have a significant and bonafide involvement in the property, they have to own more than 10% of the property which means any partnership is going to have less than 10 people in it and the active rental property loss is phased out between \$100,000 and \$150,000. So as your income going up your ability to allow tax losses from the real estate to slop over and shelter gradually evaporates and disappears altogether after \$150,000.

To determine whether that activity is active or not, if a net amount is a loss, the adjusted gross income on

occasion is applied. If the net amount is income, the amount is combined with other passive activities. To determine the net other passive activity the net amount is a loss, the loss is not allowed except for a certain phase in possibility. If the net amount is income, it's taxable. The phase-in rules allow 65% of the net passive loss in 1987, 40% in '88, 20% in '89, 10% in '90 and after that zilch. Passive activity is engaged in after the date of enactment do not qualify for the phase out rule. Nondeductable passive losses carry forward until passive income absorbs them or the activity is disposed. You have an unused portion of passive income loss you can apply it against the capital gain on sales to compute the base for the capital gain.

Market number two is portfolio activity--interest dividends, gains and losses from portfolio assets and ground lease rent. That was kind of clever of congress because otherwise you could have converted a good deal of your real estate income to ground lease income and therefore had enough passive income to soak up the tax shelter that you might have had from your other property and there's still active pushing by the National Association of Realtors to get ground lease rent reclassified as passive income. In which case you would then have essentially a tax free bond because the shelter on the building just might be 20 to 1

relative to the value on the land would be more than sufficient to cover the rent on the land.

Everything else falls into bucket three, though it's either passive or portfolio or it's _____. Now to decide whether its tax deductible there essentially is four level screen. First of all in the at risk rule. At risk essentially disallows the interest deduction from any long term or related parties, sellers or persons receiving contingent fees. That was one of the favorite gains in the partnership game was to invent a series of fees for the seller. So he got a consulting fee, he got a property inspection fee, he got an advisory on the organization of the partnership fee, etc., etc., etc., and put that all out in front, it was all deductible for the buyer as a first year expense and that really allowed you to hide significant the tax shelter in the first year, all that's gone. There is a provision in the tax code that says that a related party could make the loan to the buyer, the mortgage loan, and it might be treated for interest deductions but it would have to meet all of the criteria of a third party independent arms length loan and the burden of proof would be on the borrower. He would have to demonstrate that it met all of these criteria and that it did not cause an increase in price because the seller had provided this financing and that in fact it could have been obtained

somewhere else in the market place and so forth. So it's very difficult to get. The option is there for a specific set of facts. Those facts have to be relatively unique or all such related lending is not a deductible interest factor. We can have nonrecourse financing only as long as it's obtained from a legitimate third party institutional lender who's in the business of making loans. Can't create just a specific entity just for that specific deal owned by the seller and then argued a third party lender. That makes a fairly narrow window for full deductibility of interest and for that matter full deductibility of depreciation on the total property. Now, what happens if you don't meet the at risk rule? Well one, there's a cap on how much shelter the individual owner can take. He is limited to the maximum amount at risk. So if you have a \$1 million property but the seller gave in \$900,000 worth of financing, maximum of \$100,000 in depreciation shelter or other tax shelter factors could be taken and at that point the buyer has no more benefit of shelter. It was striking directly at the ability of syndicators to artificially structure excessively high prices by providing less than market rates of interest on wrap around loans provided by the seller. That exaggerated the tax base for depreciation purposes for one thing and quite often it meant that virtually all of the income on the project went to the seller and the buyer was

simply getting the shelter. And if you structured that right on a nonrecourse basis the buyer could step away from the property seven or eight years later and would have gotten one, all of his money back, two, a return of at least 10% of his money and the property would then revert to the original seller, did not have the property back. If it was done on a land contract, land contracts can be renegotiated between buyer and seller without a tax penalty on the reduction of the balance due and therefore there was no constructive receipt by the seller or by the buyer either so it wasn't a taxable event, so this plugs that one pretty good.

The second hurdle is the passive loss limitation which we talked about earlier and that passive loss application to other income presumably portfolio or current is being phased out. So that by 1990 virtually none of it is eligible beyond dollar for dollar. For every dollar of income you'd have a dollar of depreciation you can't in the passive, category but you can't then translate negative income in the passive bucket to positive income in the portfolio or your earnings bucket. For the little fella if your adjusted gross income is less than \$100,000 and your active rental loss is less than \$25,000 don't cash in your bonds to pay off the mortgage on the property. It won't reduce your tax bill. Pay off the mortgage debt if your non passive income

exceeds \$100,000, your active rental losses exceed \$25,000 and anytime you have a mortgage debt on passive rental property. In other words what happens essentially is that when you take the soft loss of the depreciation which is a non outlay kind of expense, and you tack it on top of the interest rate, your losses exceed your available income, at that point you're just burning up the depreciation opportunity until such time that you sell the property and can recoup the unused part of your shelter. What you have to do is then get less debt therefore, you have a lower hard dollar deduction on the interest rate and therefore, the shelter can slide in and cover real earnings and be used immediately. Everybody with us? I suggest than that leverage is, not the game and not as necessarily played at this particular point as it once was. Okay, passive activity income is earned from rental activity or other passive activity but notice does not include interest on escrow accounts. You might be able to negotiate some small advantage by putting part of that purchase price in an escrow account. Gains on sale of rental real estate are passive activity assets. Interest earned on installment notes from sale of such assets are included here.

Okay, hurdle number three--investment interest limitations. These were never taken seriously before, they are now a significant constraint. The new law prohibits

deductions for investment interest expense in excess of investment income, and for this purpose net passive losses which are deductible are deemed to be negative investment income. So if you have \$100,000 of investment income but you have a negative passive income of say \$25,000 you then have only \$75,000 worth of passive income net, and therefore you'd only have \$75,000 of interest deductible in that period. Notice there's more than a few places where its lopped over, you cannot carry the negative tax loss from the passive category over to shelter income, but it does carry over to reduce the definition of how much interest is deductible because what they don't want you doing is borrowing money on your life insurance, say on the cash values, and paying interest to your lender under the investment account and then using that as a down payment to hike the depreciation in the passive account and carrying back that depreciation over to shelter something else to the degree that you have that opportunity. So notice what this is doing is discouraging you from collateralizing your real estate with your bond portfolio or your stock portfolio or whatever. If you get too much passive loss it will reduce the deduction of the interest, and therefore discourage you from over collateralization of the real estate with securities. There is no \$10,000 allowance as there use to was. Interest paid to related passive activity is not

investment interest. For example, if you make a loan to your own SubChapter S corporation and you get the money out of the SubChapter S in the form of interest income rather than calling it rent income then the SubChapter S is getting, doesn't count. Again, can't borrow on your investment portfolio by changing the character of the way in which you repatriate money from the real estate tax to your investment account and make it something that it ain't, doesn't count. Interest disallowed carries over indefinitely. In other words speculative land becomes very expensive game to play where as in the old days obviously if you bought investment land, has a 10% interest rate let's say on a land contract and you are in 50% tax bracket, the real cost was only 5%, as long as the land continue to appreciate at a rate greater than the net cost of your interest after the shelter factor had been applied, why you were doing well. You can't do that now. That's what generate investment interest expense are second in line to consumer loans when it comes to retiring debt. Now I notice consumer loan interest rate is no longer going to be deductible and therefore the first thing you want to get out from remember the home mortgage loan interest is still deductible as long as the mortgage does not exceed the basis of the house. Any questions up to that point?

And finally, hurdle number four is becoming a much more meaningful factor, is the alternative minimum tax. There is one for personal folks that we're talking about today. There are two alternative tax factors as far as corporations are concerned. All tax payers must recompute tax liability under the AMT and you take the greater from the two, if your personal tax is less than AMT you pay the alternative. A deducted gross income, add that to tax preferences, subtract your allowed deductions, subtract your standard exemptions, that includes the alternative minimum taxable income and you multiply that by your tax rate which is applicable to the minimum tax its not the regular 28% rate but in this case 21% and that equals the AMT. In 1987 capital gains will no longer be preferences. So if that doesn't get built back in there accelerated depreciation on all the property is a preference. Notice on all property it use to be the accelerated depreciation taken on office buildings was not it was a preferential factor but not on apartment buildings. Installment gains on dealer property or rental real estate-- that was never before a preferential item, they sold your farm and you got five annual payments from the buyer of the farm you were taxed at the progressive tax rate which applied to the lower level payment, the 1/5 of the principle the net worth minus what ever your basis was, but now that installment gain over and above the amortized basis against

that gain is preferential income. Passive losses without any phase in credit and to the extent the AMT exceeds the regular tax and minimum tax credit and carry over to the future years to offset the regular tax, that's _____. This provision adjusts for timing differences which may cause AMT in one year and regular tax in another year, so if you have sporadic aims you sell your text book and you have a spike in income one year you begin to level that out. It's really kind of a back sided income leveling device, can't average income any more but where you have a big year and owned the AMT rather than your regular tax you can begin to kind of recover that payment against future regular tax. So its kind of a backsided income averaging thing, it's a tax averaging thing instead, it's the flip side. Interaction with the Wisconsin minimum tax and the new Wisconsin rules comes in effect with assessed for 55% of any excess of AMT or a regular tax. And Wisconsin will assess tax on the timing difference without any future relief. And finally by 1988 when the regular tax rate falls 28% the impact is obviously going to be much more noticeable.

We'll go into key terminology here. Remember these are sample individuals as opposed to corporate folks. So here we have the MBA who managed to snare \$70,000 as he got out of school and his interest dividends and so forth on land contract that he got from his wife as a joint return better

than \$25,000, other income \$5,000, capital gains real estate \$16,000, others \$1,000 gross income, \$117,000. So far there's no difference with the previous law. At that point capital gain credit of \$10,000 is for the 60% that wasn't taxable, as opposed to the 40% that was under the old law. The rental and partnership losses in his real estate from apparently soft cost accounting, accelerated depreciation, and a terrific accounting scheme was \$64,000, the married couple deduction was \$2,000 which tells you something about the relative value of the wife's first property, I guess. So the adjusted gross income is \$41,000. Now, under the new law notice the depreciation cut is a little higher, the taxable income is significantly higher, but the alternative minimum tax in this case would have been \$15,500, is the minimum. Accelerated depreciation is a preferential item. Itemized deductions--pretty much self-explanatory. Interest on the home mortgage is still deductible, interest on land contract still deductible, the minimum tax however, does not consider that. The investment factor (end of side one) notice \$9,000 in the first case, we're only \$5,900 in the second case because of the investment income is less than that--that's that interest and dividends thing and so forth. And the consumer's deductible interest \$2,000 under the first plan which was the old law, and \$1,300 under new law is being phased out _____ 65% in the first year of '86

was still deductible, now it would be less than that. And the miscellaneous is further deducted from \$3,000 to \$1,800, so the total itemized deductions were \$32,000 under the old law, \$26,500 under the new law. The personal exemption, however, has gone up considerably, but the taxable income when all is said and done in '86 was \$5,000, \$23,400 under the new rule and \$31,500 under the alternative minimum tax and the income tax is \$500 in '86, \$3400 in '87 or \$6600 under the alternative minimum tax and so they would have to pay the alternative minimum tax. Supporting notes and assumptions are on the previous page.

Similar case, what happens now if the tax payer is positioning himself for real estate, refinances the house, pays off the consumer loans and has more investment interest and we go through virtually the same scenario and where his '86 tax thing it doesn't change its still \$500. Under the '87 tax law it's down to \$2800, but the alternative minimum tax has dropped from \$6300 or whatever it was to \$4300. So he's obviously better off to refinance the house, pay off the consumer loan and modify his investment interest factor.

Now at that point example three says having repositioned himself relative to that aspect of the law, what happens now if he cashes in his other interest and dividend assets and buys a passive income asset or pays off rental debt obligation. Here he is again with \$70,000

income, land contract at \$25,000, we don't know what the other was but he's paid that off and his real estate is \$16,000 and his other is \$1,000, gross income \$117,000 versus \$112,000. His capital gain deduction of course, is nonexistent under the new law. His married couple deduction has gone up, his partnership losses have gone down and his adjusted gross income is now \$41,000 in '86, as opposed to \$55,000 in '87. Now we look at his itemized deductions virtually all of his taxes are deductible. His interest deduction has gone way up, notice \$13,000 for his home mortgage versus \$2,000, the underlying land contract, etc., as a result his total itemized deductions are a little bit higher, and his personal exemption is still of course what it was before and his taxable income has dropped a little further to \$2,500 and his alternative minimum tax has dropped all the way down to \$3,100. Obviously just looking at that format when you get to Mr. Clifford you may have to reconstruct Mr. Clifford the same way in terms of structuring the individual, positioning him for real estate and then coming up with a balance asset account. Assets obviously we'll build so that his shelter matches his income in real estate. That's a little tougher to do than it once was, but obviously a critical element in trying to avoid the alternative minimum tax. Questions up to that on the exam a fairly typical basis. Question--(can't hear it). Chief--

That's right, there isn't one available any more and it just dropped out of the _____ I believe as well. The last time you will vote for Reagan right? Can't afford it now. Okay, any others?

Okay, let's start to build on that. The basic elements of the tax strategy first of all is the acquisition, really has to do with what kinds of shelter do I want, if any, are determinant of my investment. Second of all, recognition that once you buy a property you are likely to be in it for a relatively long period of time. There's no advantage in taking the capital gains anymore since the tax rate is the same as on income, you usually obviously get the benefit of a multiplier if you create move the income from \$10,000 to \$20,000 and double the value of the property, why you can sell it and take the capital gain and pay the tax all in one lump sum, but presumably you would have saved the same number of dollars in tax if you had taken that income of \$20,000 a year on out for 10 or 15 years and so forth. So obviously in looking to real estate, you want real estate that one, has durability and it will be able to sustain its value over the longer term and two, can be enhanced, that by careful tender care and some further investment in the property, you will be able to increase the value of the property and transfer it to your heirs at a price significantly higher than you paid for it so that they one,

will not pay the capital gains tax and two, can begin whatever depreciation there may be available at that point in time all over again from the new basis on which they may have paid inheritance tax.

Duration we mean the ability to improve the property. Talk about improving real estate property by the way Disney for a variety of reasons had to buy Arvida in order and issued stock on a merger of interest or exchange, so that the Bass Brothers would not have to pay a capital gains tax on the Arvida interest and the Disney people could dilute the ownership of the hostile ownership position that was attempting to dethrone the existing leadership. And the Bass Brothers received some percentage of ownership in Disney, which I can't remember the exact percentage of, but going in to the deal they had a basis of \$14 million in Arvida, they obviously made some money there, and I forget what they got paid for it but it might have been in the neighborhood of \$100 million, and so forth, which they then traded for Disney stock at a time when Disney stock was at its lowest, probably in the low 40's and two years later after all the shooting had stopped and the new management got them back on the track and the stock market once again had confidence in them, they had gone to something like \$125 a share for Disney split more than once. The capital gain of the Bass Brothers was \$850 million on a \$14 million

investment. That's how to make money. Only if we would have known that at the time. That's hard to imagine people churning \$850 million capital gain for having done nothing but meddle in the management of the company, engaged essentially in what is called politely green mail in the stock market.

Now having decided that you want a property with durability and fixability if you will, or enhanceability, the next thing you really have to decide in the acquisitions process is what mix you want between land which is nondepreciable, structure which has obviously a useful life of 27.5 years I guess as a residential sector and 31.5 for commercial property and then of course, how much can I put into personal property. Any personal property that has a relatively short useful life of 3, 5, or 10 years, the more I can allocate to the personal property side, perhaps the more quickly I can provide shelter for whatever taxable income there may be on the property. As you begin to look at that, obviously some properties lend itself more to that kind of formula than others, certainly slightly run down apartment building which you can now begin to refurbish and refurnish and perhaps provide new appliances and so forth and so on will be a more attractive blend of opportunities within the tax laws than say a commercial shell building in which there is no personal property and in which may be

doesn't really lend itself to any significant enhancement at a particular point. It certainly puts the premium on the older buildings with the good location versus the new building which is shinny and new but not necessarily as well located and so forth.

The acquisition process has to anticipate how you are going to present the building, there are several basic issue. One, what class of structure do you want to talk about, we still have four classes of structures, we have single family legal residence, we have farm and extraction properties, we have residential, we have commercial, and we have subsidized. What category do you want to be in? What category is most appealing? Let's say for example, you buy a single family residential home, you want to make that your legal residence so that as you pass 55 you can take all of the gains as a one time life time exemption from the capital gains tax, or do you want to rent? What if you're 51 years old, or excuse me 47 years old and you want to sell your house and then you say gee, no maybe I'll just rent it for a while the market's kind of lousy. And you move to a new town and now you rent the house, the legal residence changes over to the next house, what do you do with the one you just left behind, you rented it for a few years, I believe there's a what, three year carry back on that so you can rent it before you sold it as long as you don't run over

that time period, but you just blew all of your shelter in that house. Renting that single family home which you owned as your legal residence and now you changed the legal residence you made that a commercial property you just lost all of the capital gains shelter and so forth. Obviously you don't want to do that so it's important to know what the category of your investment is and do you want to maintain it, how do you want to establish it. You buy a home, how many months do you have to make that your legal residence in order that you can begin to protect the capital gain exemption on resale. They want to call it a farm and extraction property. We have what are called hobby farms because for a while that was a popular thing to do--buy a farm, raise a couple of horses, run up the net losses and charge it off to the income taxes maintaining it being a bad deal--you can't do that any more. Gotta make money on the farm 3 out of 5 years so it's a hobby farm. Okay, how do I do that? What if I lease the farm to a farmer, what kind of income do I have? I have passive income - I have rents. On the other hand, if I go to a joint venture with a farm and he and I own 50% of the cattle and 50% of the equipment and so forth and so on, now I have a joint venture, that's not rent, that's operational income from operating the farm, taking a little bit more liability but it does two things for me--one, I can own the farm in SubChapter S and protect

myself on the liability, I don't have rental income so it doesn't run afoul of the constraint on the rental income on the SubChapter S and so forth. The first thing I want to know is what category am I in? Do I really have a farm? Or is it a resort? Or is it an extraction property? How do I prove it's an extraction property? Sometime you can be just too smart for your own good. I bought an Applewood Hill Orchard I wanted to make sure it was a farm property so that I could depreciate the trees after all trees are depreciable. It said I had to try and raise apples for a minimum of three years after I bought it. Then I found out there was a hell of a lot more to raising apples than I had ever imagined before, including something like 17 sprays that cost me \$150 each and when you're all said and done then the question was who was going to pick the apples. If you succeeded in raising apples you were in big trouble because there was nobody to pick them. The priest from Holy Name Seminary came over the fence and had a wonderful time and sold cider at the church social and they made a hell of a lot of money. So God bless my orchard. Then I discovered gee, if I had just given a double dose of DDT after the first bloom, somehow those blooms never became apples so our sprayer made a terrible mistake, he hit it with a double solution of DDT and I never had any apples again, but at least I had made my three year effort to raise apples and

fall in the farm category rather than the hobby farm category. But then I made my first mistake. I sold the lot, before the three years was up now I had to go back and count the apple trees on the lot by species mind you, figure out what the depreciation base was on each tree by species and refile my income tax for the previous two years and compute how much I owe the government for the depreciation I had taken which had been on trees which were not in business for three years. Do you have any idea of what the accounting costs on that little operation was relative to the tax savings, no match at all. I spent about \$3,000 at being clever, so you really have to begin to figure that out and question is do I want to be a farmer, do I want to be an extraction property, how much gravel do I have to take off the property before I'm an extraction property, do I have prove up the _____. Residential isn't too hard. I believe to be residential is at least 80% of the property has to be residential. It grows out of the leave of the old FHA rule that you weren't entitled to FHA insurance on a residential property unless at least 80% of the income and 90% of the space was residential use rather than commercial. If on the other hand, you fall below that if I recall rightly you have to split the building between the two categories. Then we're too commercial. Then we're finally down to subsidized property, well there's a variety of

subsidized types of property, obviously there are the Section 8's with direct rental subsidies in one form or another, there are those properties which are financed with below market loans by the state housing finance agencies, small business administration, farm home administration, possibly local agencies and so forth, the government is fanatical about double dipping so that if you fall into that category, if you have one of those loans, then the investment tax credit that you could take on the other side is reduced from as I recall 9% to 4% on let's say a new residential property for low income, followed by low income people and so on. So you gotta know which category you're in.

The second thing you gotta know in your acquisition process is for what purpose am I acquiring the property. There are three general categories: One, for use in a business. A property acquired for use in a business has slightly more generous write-off terms and you're entitled to take the ordinary losses on sale of that property against other income. That's true even if it's a proprietorship. At a corporation in which passive income doesn't come into play at all which is another good reason why you might want to go in joint over status _____. Second reason would be for investment and appreciation. And the third reason is called dealer status, i.e. the property is simply on their

inventory, its available for sale like any other kind of trade goods as opposed to the retailer that can have it up on the shelf you've got the building out on a lot, you took it on a trade and so forth and he can obviously turn it over and sell it again.

Now, think of a Realtor, think of yourself, approaching any one particular property you could be any one of all three of these or indeed the property could be two of these. You might buy the building to house your operations as a real estate broker and developer, in which case you bought it for use, and therefore, whatever little goodies there are under that category would be applicable. On the other hand, you could maybe split the property in two and have the office building that's yours as a purchase for use and then have the balance of it and you and mama's pension account as an investment for income and depreciation and be an investor for investment for a position in which case you're entitled to capital gains tax and so forth and so on although that's not much of an entitlement being put all your eggs in. Or third, you bought it as a dealer in which case you never get capital gain status. A subdivider of lots as a general rule is a dealer. He has created stock and trade. His whole product line is there to be sold just like somebody else created cheese and somebody else created cars and whatever, he's not entitled to capital gains. Two exceptions to that,

one, if a business acquired the land for another business purpose which became unnecessary, technically obsolete or whatever, they would be allowed to dispose of the land as a subdivision and so forth and not be a dealer that could take a capital gain on it, in effect its simply a disposition strategy to the benefit of an investor for use where that use is no longer applicable or relevant i.e. the rubber company that bought all the irrigated farms in Tempe, Arizona, to raise cotton for tire cord and then we went to rayon and nylon and so forth, they were allowed to subdivide all of Tempe, Arizona, and take it as a capital gain. The second is where you inherit the land, again inheriting a piece of land which you then further subdivide is simply a way of disposition, more optimal disposition for you and one of course, your basis is the value of the land at the time you took it and it and gain over and above that is the capital gain not an ordinary income gain for what little advantage that may give you today. It's important to know how you are categorized and it has been suggested one of the ways to move real estate income out of the passive category into an earnings category is to be a dealer. So it may be in the old days you leaned over backwards never to be categorized as a dealer. Guys who had never gotten their broker license for fear that was prima facia evidence that they were a dealer. Now today you kind of like the options

of whether you get your broker's license and try to establish an audit trail, you really are a dealer. Take the income out of the passive category and eat that through and through. So we need to know those three categories.

The next thing that we need to know in the acquisition strategy is really to anticipate when we had planned to acquire and when and how we plan to dispose. And where we want the profits to fall. We're going to structure our acquisition to accomplish whatever the purposes of those may be. For example, if I decided that I would like to have the income only on my retirement to support my fishing vice and so forth, I might to decide to acquire his property through my little pension fund in my corporate shell and the income would go to amortize the mortgage, etc., etc., etc., but none of it would be available to me at this time. Only when I bought out of the pension fund would it then be subject to a pro rata tax. On the other hand, if I didn't want it for my pension fund, and I wanted to give it to my kids and this was a wealth transfer device, at that time I might use a tax freeze holding device such as a family corporation with two classes of stocks--preferred and common--and I give my kids the common, the preferred stock would be exactly equal to the purchase price of my property and gradually I would call the preferred, any appreciation in the property would all go to the benefit of the common, and when I died the only thing

in my estate would be the common stock and would be automatically valued at the call price and all the wealth increment would have been transferred to my children without benefit of the gifts tax, without benefit of the inherent tax, and no charge in terms of administration on my estate. So I want to know hey, where is this property going to go, where is this wealth going to be diverted to? On the other hand, if I say gee the play is to give me a little leverage so that I can trade up now what do I want to trade? Well maybe I want to trade stock for stock. Or maybe I have to acquire it through a corporation and so forth, so that the basis is in the corporation. If I acquired it in my own name and then put it in a corporation later, the only basis the corporation gets is the basis I had when I bought it. So the question is, you know, which set of books do I want to keep or which is a particular advantage. So I need to know, when do I want to acquire it when do I think I'm going to dispose of it, and where do I want for that profit to land? Corporations do this all the time of course. Trying to decide how to register it for their own particular corporate purposes of earning per share at a certain quarter. Perhaps getting an out from the corporation and hiding it as a submerged asset. In some cases they want it to appear as a big bonanza and in other cases they don't want it to appear at all. The less the people know what my

real net worth is the less likely to have a raid-- corporations today are very sensitive to that. As soon as people figure out wow there's a lot of real estate in that corporation, the raiders are there to say maybe if I acquire the corporation and then leverage the real estate, why then I only have buy-outs right? And you may just want to spin off some of the crown jewels of the corporation and bury them here and there, so that's its not quite so apparent anyway from those that don't do a great deal of research as to what your real estate position may in fact be. Now, given those considerations then the acquisition of piece of real estate gets to be a fairly sophisticated play even for something as basic as a four unit or an eight unit or small commercial property with a triple net lease on it or whatever else the investor is still looking at in his range of price and down payment available.

A further element in the acquisition formula obviously is to refine the kinds of assets acquired. What class do I want them to fall under in the IRS code? Three, five, ten year category? What evidence can I have to allocate the purchase price to those categories that will with stand the IRS scrutiny. Do I need a bill of sale for the equipment and furnishings? Do I need perhaps a statement as to what the land was purchased for as vacant before I acquired the property? To what degree is the assessment ratio of land

versus buildings apply, do I need that piece of evidence to establish again the audit trail of my allocation, the IRS doesn't necessarily be bound by it but they may be. There's one comfort that you have as a small investor is that it maybe not worth the effort by the Internal Revenue Service to pursue you and the one so you want to push it of course as far as you can to your advantage which is the holler theory of tax allocation. Allocate it the most favorable way until the IRS hollers then you holler back and then you decide if they're really going to make an issue of it or decide that the revenue benefits to the IRS don't match the cost benefits of sending an agent out there to do all that and you arrive at some small compromise which allows them to indicate that they collected some additional tax from you at no great loss face for their agent. The holler theory - most tax _____ are based on this basic premise. But obviously the initial move is for you to push them as hard as you can under the law until they holler and most accountants and most CPA would tell you if they haven't hollered you haven't pushed them hard enough. If you didn't get them this year try them again next year. Okay, we'll pick up again on this on Wednesday. (end of tape).

Announcements for jobs at Prudential in Atlanta. Four full time jobs posted on the job board.

Today we've imported expense and cost. He has graciously agreed to take the pressure off my poor voice as I'm supposed to be lecturing in Atlanta tomorrow and to pick on investment tax credits, I'll turn you over to Mark and then chip in from the sideline. (Mark makes a few announcements.) Mark says people had questions on the case studies one of them was effective versus contract rents. Contract rents are the rent stated on the contract so if you've got \$12 a year that would be your contract rent. Your effective rent is your contract rent less your free rent, so if you have, let's say, two months per year free rent, you would have effective rent of \$10 per year. Also, another person asked about the squeeze down formula. Chief--A squeeze down is a joint venture agreement in which both parties agree to provide a certain amount of equity capital initially, and then if the project doesn't run according to budget and additional funds are needed, one party, probably the financial partner, puts in the additional funds for a stated amount, let's say another \$500,000, and party number two goes from a 50% position to a 25% position. And then they if they have to go through a third stage of funding, let's say the carrying costs because the project isn't marketing very well or isn't filling up and so forth, maybe the second time around he's out all together. You know, he ends up with a zero position in the joint venture or

sometimes gets reduced to a slow pay subordinated note as we'll talk about later. Courts will not generally enforce total application or wipe-out of your equity position as being too hard to remedy for failing to meet the call for additional funds, but will allow you to change your position from that of the joint venture partner to a limited partner or change your position from an equity position to a subordinated slow paying note in which interest is at 5% and accumulates for payment ten years down the road, and so on, so they can't say they cheated you out of it, they still owe it to you but it's going to be a long time before you see it, so that's called a squeeze down.

Mark -- are there any more questions? Further clarification of effective rent. Free rent normally comes at the first part of the contract and then the free rent is pro rated over the life of the lease. Chief -- It used to, but now today they've found today that what happens is if they give you six months free rent up front, you'll leave at the end of six months and argue that for some reason they've breached the contract because they didn't do that, and so forth, so if they were going to give you six months free rent on a three year lease, for example, they'd probably give you two months free rent at the beginning of each year. So you work it out over time. I think what you have to do is just assume it's leveled and the effective rent is the

controlling factor. Question--So depreciation on the buildings is 7, 19 or 31.5 effective right now. Chief--no we're assuming today 31.5. When they said in 1986 when they were doing the deal, remember the depreciation wouldn't start until the development had been made so even if you cut the deal in '86 you would not have been entitled to the depreciation until '87, in which case the new law would have applied any way.

Mark--we'll cover three areas of tax mainly. First would be a real short thing on deductions, and some on credits, explain a little bit more in depth passive losses and then maybe some miscellaneous things. First off deduction and credits--deductions in depreciation are subtracted from the gross income to reduce taxable income. So a dollar deduction is worth \$.28 if you're in the 28% tax bracket. A credit, because it's a rehab credit, is a dollar for dollar deduction in tax liability no matter what your tax rate is. So if you have dollar credit, you have a dollar in cash savings. Real quick on depreciation--real property for nonresidential is 31.5 years, for residential it's 27.5 years. Personal property, as Chief mentioned the other day, is mainly 7 year property. There are 3 year, 5 year, 7 year, 10 and 15, 20 year, but it's mainly 7 year property. There are other nonstatutory ways to depreciate real estate and a good example would be the Hertz

Corporation, when they purchase their cars and rent them for a year they quickly realized that the depreciation that they were actually taking on these vehicles was greater than the amount of the depreciation that they were allowed per the debt and hence they used what they have had proven over the years to depreciate their cars. So instead of using a statutory 5 years that they could use, they use something greater than that for their own formulas. And the way that comes in real estate is that tenant improvements and leasing commissions and those would be improvements specifically for the rental of estate in which improve the life of a building or wouldn't be capital improvements, it would also be depreciated over their life. If they have a three year lease and you put in \$3,000 worth of tenant improvements, you depreciation over the life of the least of the 3 years. Chief--By the same token when McDonalds changed their marketing strategy to include seating in-house they were able to show the rate of obsolescence of fast food configuration and structural things was perhaps 7 or 8 years before they went into a new cycle of changing your image and so forth and so on. As a result, they can use say an 8 year useful life on what most of us would have considered real estate simply because the rate of obsolescence relative to marketing was that quick in that business. So, if you keep the historical records and can demonstrate that historically

your useful life of that particular component is shorter than allowed per the code why then you can establish your own useful life.

Mark--Next on the outline is what is called Section 179 Rapid Expenses. And that's was expanded per the '86 tax law and it's used mainly by small businesses or individual businesses, a small appraisal office would be a good example. And what rapid expensing is, is you are able to take Section 38 property which is personal property used in a trade or business and take a \$10,000--up to a \$10,000 expenses. Chief--that's tangible personal property. Mark--A good example would be let's say you bought a computer and printer which totaled \$12,000 of cost for your company. Instead of having to depreciate that over the five year depreciation schedule you can actually expend up to \$10,000 of that in your first year. That also does reduce your basis so your depreciable basis must be \$2,000. If you purchased more than \$200,000 of personal tangible equipment used in trade or business, you start to lose this benefit. So it's mainly for the benefit of smaller businesses.

Credit is the next thing on the outline and as most of you already know, the investment tax credit was repealed retroactively to 12/31/85 and most of you know these new tax laws took effect on Oct. '86. Like I say the investment tax credit was repealed retroactively 10 months so in the future

don't be surprised if they do implement different statutory items that are actually retroactive. So it does pay to keep yourself in tune to the tax law changes because it does make a difference on your investment scenario. The investment tax credit was mainly used as a device to stimulate the economy. It's been implemented and repealed many times over the past couple of decades. And one of the credits that is law and mainly for real estate is the rehab credit and it covers somewhat less than in 551. The old law gave a pretty generous 25%--we'll cover the old stuff first and then we'll go to the new stuff-- 25% investment rehab tax credit if you were on the national register of historic places. And you only had to reduce your basis in the property by \$.50 on the \$1.00. So if you put in \$100,000 worth of stuff you got a 25% investment tax credit, plus you were still able to depreciate \$87,500 and from there was a 20% rehab credit for buildings over 40 years and a 15% rehab credit for buildings over 30 years. The new law you get 20% for certified structures, again on the national register, and 10% credit for buildings built before 1936. So you have to have a building that is 52 years old. Chief--There's an additional constraint in there, isn't there, that your total rehab costs has to exceed the purchase price or the improvement price - the rehab cost has to be greater than or equal to the adjusted basis of the purchase price which

means that, obviously, if you're negotiating a building for rehabilitation purposes you want to negotiate the lowest price for the building possible and if necessary compensate the seller through other means so that you're not forced into a rehab budget that really exceeds the needs or what the project can carry in terms of extra dollars, so at that point it becomes very important to shift the purchase price away from the building and the land underneath it. Mark-- There is 100% reduction in basis for every dollar taken of rehab credit so if you do get 20% rehab credit on \$100,000 you have reduce your depreciable basis by that \$20,000.

Moving on to passive losses. As Graaskamp went through in lecture on Monday, there's three vested incomes, and I'll try to put some examples on the board to clarify a few of the issued held therein.

First off there's compensation which is way to tally portfolio income which is stocks, bonds, and securities in general and it's passive income, which would be limited partnership. You cannot offset passive losses with other types of income, portfolio income and compensation income and the only person who this doesn't apply to, would be to those who materially participate in the deal. And as Chief was saying you almost have to be a dealer in real estate even to be a material participate or a general partner. Even in many instances the general partner does not need to

materially participate. In order to keep the classification of passive income on a limited partnership, let's say you bought a \$100,000 limited partnership, you also have to actively manage or actively become part of the management and once you become an active participant in the management you start to get on that very fine line of whether you are a general partner or a limited partner when it comes to liability on property. Chief--Or you will become a general partner whether you called yourself a limited partner or not. Limited partners are permitted only three decisions, three areas of discretion, sell, refinance, or get rid of an incompetent general partner, and that's all. And they had cases in Milwaukee, for example, in which one of the limiteds after the big snow storm went over and commissioned someone to plow out the drive in the parking lot to get things going and signed a receipt for the snow plow. The driver had completed the work and that blew his cover, he was at that point a general partner, as far as the IRS was concerned and so forth. Passive income is virtually any kind of rental income whether you're a limited partner or not. So the form of ownership isn't the critical thing, it's the source. Darrel Wild can be both, he can be a general partner and he can be a limited partner up to 20%. 20% of ownership. Question--on management service is that considered passive income or not. Chief--If you're a

property manager and managing your own property and you're managing it in your own name as opposed to the company name which manages property for other folks too? (student clarifies) I would think they would still call it passive income because you have in effect offering that service to a wide variety of people. Well all your earned income can go up to \$125,000 before you've lost all tax shelter, as it were, from the tax category. If you make \$100,000 or less, \$25,000 of negative shelter from the passive income to cover your taxable earned income. Again, designed for the little guy rather than the big guy and it's hard to recognize that you have a lot of husbands and wives filing a joint return, both working, they own a couple of duplexes and they take the income from the duplexes and so forth they're getting close to \$100,000. You know, today that's covering the blue collar family. Dad may be at \$40 mother's at \$20 and the real estate carrying \$40,000 net income, okay, that at a point they're \$100,000 and the tax shelter steps into their advantage. Once you go above 125 as I recall you're phased out. Mark--From there, for real estate only is one exception and that's real estate can take up to \$25,000 of passive losses against other income and that's if they own more than 25% of the deal and also are not participants in the deal. And as Chief said any \$100,000 starts to pay out at \$.50 a \$1.00, \$150,000 where it's a \$25,000 write off and

from there let's put a few examples on the board that make this clearer.

Mark--Let's say you've got two partnerships, Partnership A and Partnership B, and Partnership A is putting in \$20,000 of income and Partnership B has losses of \$50,000. And let's say your taxable income is \$100,000, so it stays up but it's not yet started. What you can write off here is you can write off up to \$25,000 of your passive losses against your taxable income and you come up with a \$75,000 taxable annual and you'll have to carry forward and the carry forwards are on an indefinite basis \$5,000 which is the net difference here between 50 and 20 or 30,000 and you can use \$25,000 in losses, coming to \$75,000 taxable and you have \$5,000 of passive losses that are carried forward. On another example, let's say we keep this same example, but instead we have \$120,000 of taxable income. We have \$120,000 of taxable income due to phase out between \$100,000 and \$150,000. We have lost an additional \$10,000 of passive write offs that we could take so this year we only could take \$15,000 of losses against \$120,000 and that's \$105,000 and then we would have a carry forward. Carry forward of \$5,000 and here you have a carry forward of \$15,000. \$25,000 coming from your passive losses. While here's a gain and here's a loss and you have a net passive loss of \$30,000. Chief--so he can pool that and arrive at a net

loss or gain. Mark--So he can write off \$25,000 per the statutes against other income--your compensation income or portfolio income coming up with taxable income of \$75,000. In the second example I could take _____ \$15,000 in passive losses in that year. Because right here you have a net passive loss of \$30,000 you can use \$25,000 this year, which would mean you have \$5,000 left to carry forward in the future years. So let's say next year now you have \$100,000 of income again, but this property has given you \$25,000 of income and this one will have \$40,000 of losses. You can use the carry forward the next year. Chief--You have nothing to gain by postponing it and everything to gain by considering the present value of money and reducing the tax this year. Mark--The carry over would be net and the most you could possibly take would be \$25,000 in the second year for this example. With this other carry forward you would add this together and your accumulated carried forward would be \$20,000. And that is carried forward indefinitely or till sale. And on the sale of the property we have an example, all your passive losses can then be used. So let's say you have a property with a net sales price of \$180,000 and let's say your adjusted basis of the property is \$100,000 coming down \$80,000 of taxable gain but you also have \$60,000 of passive loss carry overs or what they call suspended passive losses. At this point you would net the

whole thing out to a sales price and come up with a \$20,000 taxable gain. To carry this out one step further, let's say you only a selling price of \$120,000 and you had your same adjusted basis and you come down with a tax gain of \$20,000, but you still have the \$60,000 passive loss, can you use the whole thing? Yes. Upon sale the \$25,000 limit does not apply so what you have you have a net loss of \$40,000 of which you could net this \$40,000 from your other income at that time. Chief--Notice one of the things that is in the acquisition process that you want to begin to think about is what do I want to acquire, the tax entity or the real estate? If let's say this is a real estate entity that was set up in 1985 and enjoyed the tax law that was in place at that point in time, perhaps I'd rather buy the stock or buy the whole partnership and continue forward on the accounting entity that was in place under the old rule. By the same token let's assume that the real estate has a substantial suspended carry forward and you might want to buy a corporate entity or the business entity in order to have that carry forward available at some point in the future and the seller might have reasons to do that to, or you may want trade stock for this corporate company and go forward with that extended entity so that if valuable, you may want to sell that extended entity for reasons that might be appropriate to one seller or another seller. In the

acquisition now you not only want to consider do I want to buy the real estate per se, or do I want to buy the asset directly or do I want to buy by myself or whatever other entity it comes in. Mark--From there _____ differ from the handout we got the other day, you can take credit, that's a rehab credit for passive losses is also, what you have is a credit and as I was mentioning before that was a dollar for dollar reduction in taxes so what you have to do is you have to take your, let's say you have a \$1,000 credit, you actually have take that and divide by your tax rate and point two eight to determine how large of a deduction you need to cover that credit and you would come up with \$3,571. So in order to cover a \$1,000 credit you would have to use up \$3,570 worth of deduction because of the difference in the two. Is that clear? And when it comes to using the deduction versus the credit, deductions, are passive loss deductions always used first and then the credit they use that. Any questions on the passive losses? Question--I'm confused does the passive loss rule apply to individuals as well as corporations? Chief-- It does not apply to corporations at all. You might want to be a corporation and apply as individuals. Striking directly at the sale of real estate positions that were denied a shelter current income, so if go to the corporation thing, the whole issue drops away. We're talking about only individually

properties and single conduit factors. I'm sorry I'm talking about the tax investment credit. In another words, if the corporation had depreciation rules that applied some 386 rule or tax investment credit that they haven't used yet and so forth, you much rather by a corporate entity rather than the asset. Mark--you can deduct \$25,000 in any one year of passive losses and that's a deduction and when you have a credit, that's dollar for dollar reduction especially have to do you have to make the credit that same as the deduction in order to do that when coming up with the \$25,000 maximum loss you can write off against other income, you have to end up dividing by .28 and this is what it would take to use \$1,000 worth of credit of a rehab credit or a tax credit. The application would be say let's say you have a property where you have deductions or losses of \$10,000 and you also have another \$1,000 of credit. You can write off up to \$25,000 of against that income. So you have \$10,000 of your deductions and how much of your credit can you use. In this case you can use the whole thing because it doesn't go greater than a \$25,000 limit. Now let's say you have \$10,000 and it becomes \$35,000 of losses now you only can \$10,000 of your deduction but \$15,000 to \$35,500. Chief--then you fall into what the ultimate tax formula. They're going to get you one way or the other. Mark--If you're in the 28% tax bracket you wouldn't be using this.

As you reveal the tax bracket you won't need these deductions or losses anyway. Chief--Essentially the individual and you might work through that for them, show them that essentially by the time you're over \$100,000 you have an average tax on everything of 28%. You get a reduction initially in the first part and then you get a hyped up tax rate on the next portion and that averages all out and by the time you go over \$100,400 or something like that then every dollar you pay in taxes is 28%. Essentially there are no progressive tax rates.

Mark--For the individual who makes between zero and \$17,000 you're going to pay 15% taxes on that money. For the individual who makes between this is for a single person, assuming a single person is similar to the married person brackets are higher. For the person making between \$17,850 and \$43,000 you have to pay \$2,677 and 28% tax on anything over \$17,850. From \$43,150 to \$100,480 there's actually a 33% tax rate and you go well I thought we down to a two tax rate system, this isn't 28%? What is being done here is on the \$17,850 they pay the 28% tax bracket less the 15% tax bracket, in other words they're trying to come up with a flat tax remodified flat tax here. And they say the difference is 13%. And you multiply that 13% times \$17,850 and you come up with an additional tax of \$2,320 and they take that number, divide it by .05, because the .05 is the

difference between the 28% tax bracket and the 33% tax bracket where they're actually beginning to recapture you difference between the 28% tax bracket in the medium range and the 15% tax bracket in the lower range. Then it comes to you have to make an additional \$46,000 to recoup this \$2,300 that you would have been taxes at if your whole income was taxed at 28%. Additionally what they have is a personal exemption, we always take one. In 1988 of \$19,500 and they do the same thing with that coming up with Chief-- \$19,050 or 1,950? RATS (laughter). Mark-- \$1,950 And when you add them all up and you come to this amount what you'll have at anything over and once over \$100,000, once again taxed at the 28% tax rate, but every dollar at this \$100,000 mark is taxed at 28%. Your marginal tax rate is 28%, your average tax rate is 28% at this point. And that would include taxes on your personal exemption. Chief--It's only you that has elected poverty as a student that enjoys the 15% rate with no further recapture. But who said Reagan never did anything for you. The other big favor is that real estate of course was the neutron bomb, but that's

_____.

Mark--A few words on some miscellaneous things, the first thing I want to bring up is the No Compete Clause, that's kinda of in a buy but let's say you're selling a shopping center and you're a develop or I'm buying one and

I'm a pension fund syndication and I realize that if I buy the shopping center for \$2 million that I have to depreciate the shopping center over 31.5 years. But now let's say I buy the shopping center for \$1.7 million and also pay the developer another \$300,000 to not him compete with me for let's say over the next three years within a three mile range. Because I know if he comes in and builds another center I'm dead in the water, he knows all my tenants better than I do and he'd just take them all. And what you would have is you would have \$300,000 which would depreciate over its life and since the No Compete Clause for three years you can depreciate that \$300,000 over three years. That's one way that a lot of syndicators were playing with the numbers but what was happening is the IRS was tripping them up a little bit and that they would look at both sides of the transaction and the developer who comes and not compete for \$300,000 was taking that income as a capital gain income and an No Compete Clause is the ordinary income and they were tracing the transaction back and forth but that today that won't make it much of a difference but let's say you were back in 1985 where there was a 50% tax reduction for capital gains versus ordinary income, you have to be careful to make sure that he's going to recognize this No Compete Clause as ordinary income and you're able to depreciate it over three years to make your numbers work easy in the early years of

the transaction. Chief--He can also charge you other fees for example from consulting fees to let's just deal with the take over of the management, you might pay in leasing commissions on the remaining income from rental contracts already being in place and in effect being purchased and assigned for the acquisition of the rental building and so forth, all of which allows you to accelerate the depreciation on that portion of your investment and the total dollar paid still adds up to what you were going to pay for the shopping center. So there's great deal as I mentioned in one of the earlier lectures creative accounting year in terms of whether did I buy a tangible asset which would be the brick and mortar and the land, or whether I bought an intangible asset in the form of leases or in the form of consulting purposes and an No Compete Clause and whatever, the more inventive you could get, the more fees were being closed out of the transaction and the lower the real estate prices appeared to be from the seller's standpoint, if it was ordinary income maybe he was able to sell to that in another way, and from the buyers viewpoint it gave him an accelerated write off which meant that the limited partners were coming into pay for their development or investment for three years and generate enough shelter over the rapid write off to, in effect, be just simply transferring into the partnership and tax savings for

another income. And we're trying to balance those off. Uncle can be spiteful as he rapidly as he can.

Mark--From there I have just a few notes on syndication costs. The first one is what I'm going to label as three different types of costs to the syndicator. The first one would be to organize the partnership. And in organizing a partnership you can write those costs off or amortize them off over a period of 60 months or longer. The second area is for the costs incurred to acquire real estate. Those costs must be added to the basis of the real estate. So if you bought the property for \$2 million and it cost you an additional \$20,000 to purchase to get all the legal and everything else for the acquisition, you add that \$20,000 to the \$2 million purchase price and have a basis of \$2,020,000. Chief--If you segregate those costs which are for the lender's purposes, would be amortized over the term of the loan. Costs which are for the equity purposes would have to be amortized over the depreciable life of the real estate. If you have a 10 year loan on the residential property at 27.5 whatever year life, the engineering inspection of the property would be relative to the longer term - the appraisal cost for the loan because it was specified by the lender and would be amortized over the life over the loan. There is some ability to match those expenditures. Mark--The third category we have here are the

costs incurred in marketing fees limited partnership and that would be the brokerage commission that goes to the financial planners or to the people that actually sell the property and those you can't write off at all. You simply deduct those from the sales price and there's no deductions as you go along over time.

The last category I have here are the master limited partnerships and for all practical purposes at this point, I think they're dead in the water, but I think they're worth pretty much as an example of the way things can happen with other investments. Originally, master limited partnerships were set up to be passive income generators. In other words generate passive income to offset passive losses such as the example that I set up here earlier on limited partnerships that many people bought and the deep tax shelter partnerships were in vogue. And per December '87 regulations, master limited partnership income of NOP's were considered to be portfolio income and as the master limited partnership is a partnership that's traded on an organized exchange mostly, like the New York Stock Exchange, the over the counter market - they deemed it to be a corporation for those purposes and have put income back in the bucket of portfolio income. Additionally, starting in 1988 maturities master limited partnerships dead in the water is that they will be deemed corporations. They're given the title of

master limited partnerships, they're going to be given as far as the tax courts are concerned, they're going to be deemed a corporation and as a corporation they will be double tax entity and that would be a double tax entity for the most part. Chief--Most of the knowledgeable people in the tax business knew that was coming but the syndicators of course jumped on the MLP, as a loophole, and the other problem of course is they generated so many dependent fees putting together that the more people that got suckered into an MLP before the door was closed, pocketed the fees and as long as they had a big paragraph on prospectus that said tax status of these isn't quite clear, that the tax status change at any time and that's part of the investment risk test and that's all they have to say. And Charlie Cluts doesn't read the prospectus and doesn't know what it said why that's his problem. Mark--That's about it as far as I what I needed to do. Chief--Thank you. Question--Can you give an example of that _____. Mark--Okay, let's say you're selling a limited partnership shares and you sell one for \$50,000 you have a financial planner or Merrill Lynch or who ever sells these things, he'll sell them usually at a commission rate of 6% to 9% and let's say 6% in this instance it will cost \$3,000 to sell this particular limited partnership share. This share, this \$3,000 is not deductible currently as an expense, you cannot amortize it,

the only time it comes into play, let's say that whole limited partnership is later liquidated for \$1,000,000 and it's \$30,000 of total commission, to come out the detailed price at the end which will be whatever, 7 or 8. Chief--It becomes part of your basis for going in. Thank you Mark.

Chief--In looking at the acquisition of the property, of any property, there are two things, considerations to keep in mind. One, of course, is the tax consideration to the seller and what he chooses to account and the second, of course, how do you want to structure it for your future tax considerations. And which works out best for both? As we argued in 856 innumerable times, ultimately the price they arrive at is engineered to lessen the impact on the seller and maximize the benefits for the buyer, depending of course on their general priorities. For example, the seller may have _____. Let's say you're buying a one day medical/surgical center type facility where in the state of Wisconsin, until recently did allow one of those let's say for community, that's a franchise, not strictly a real estate enterprise, but franchises are never entitled to capital gain, they're always taxed on sale of ordinary income. So it's really important to load the price of the purchase of that particular _____, into the real estate so that the operator of the abortion clinic or the one day surgical center or whatever, takes his gain on the real

estate value as capital gain and receives as a little as possible in terms of profit on the sale of the business where he's going to be taxed on the ordinary income basis. On the other hand, if you were buying a business which was involved with, say, manufacturing and you bought an industrial plant, with the inventory, and the machinery and so forth, it would be very useful to load as much of the purchase price into the inventory, into the purchase of existing contracts and retainers that were in place for that concern and as little to the real estate as possible so that in effect you could write off much of the purchase price against sales as a reduction in inventory value as opposed to depreciating over 31.5 years the real estate you bought. Now obviously you can't be absurd in how far the pendulum swings to one side or not, but there's a lot of room for erring on one side or the other depending on the deal and then daring the IRS to find it and then fight about it. And so the parties need to find out what their purposes are, for example, the deal of the year in terms of the SIR a couple of years ago was when Gordy Wright bought the old Gesholt Johnson plant. Gesholt Johnson had been absorbed by Giddings and Lewis who had moved all of their operations except the foundry up to Oshkosh or wherever they're headquarters was, and now they got a plant on their books which at that particular time had a book value higher than

the market value. Giddings and Lewis didn't want to take a hit on the surplus for the one time write down because the security analyst would be on top of that immediately and so they said well, tell you what we'll do, you buy it from us at our book value so it's zero balance as far as our surplus is concerned, that even gives us a small profit and we'll lease it back to you, above you, for a certain annual rent so that in effect the losses of the empty building were being feathered out again operating years in which they had taxable income. And they were converted essentially what would have been a capital loss to an ordinary loss in the form of rental expense. Then they had a release clause built in the says if Gordy Wright rented up the space and began collecting rents why then they would be released from their rental contract so it gave in effect Gordy a positive cash flow on a vacant building on the day he took it over. And he was smart enough to know that he could give away two to three months free rent and, in effect, Gesholt Johnson was paying the rent for that concession because he didn't have to take a credit against the rent he was getting from Gesholt Johnson until the tenants started to pay \$5. That's not too hard to make the deal work on that kind of basis. But at the same time the seller got what they wanted. They were allowed to extricate themselves from a surplus industrial facility where Gordy Wright took over the

operating costs, eating taxes and one thing or another they did not have to take a hit on the surplus which might have alarmed the securities analysts. They were allowed to write off the loss, in effect, as an ordinary loss against future income. And, for that matter, they were allowed to use the foundry then for another 5 or 10 years as a matter of fact before they actually closed out of that. So notice what's happening both side are looking at the tax consequences and then structuring the deal in such a way they optimize on either side of the equation. And again, cash flow available from the project Gordy was able to borrow enough money to make tenant improvements to further subdivide the building into a multiple tenant facility rather than obviously a single tenant one. Most deals are structured in that way ultimately. What does the seller need? What does the buyer need? How does FASB accounting treat that? You're going to hear a lot of that from Jay Shidler when he's here later this spring and that's really his whole game - is understanding the corporate culture and FASB accounting rules specifically to know when there's a buy point in which he can buy the property at a price lower than market price, making it appear that the seller took a profit. So let's say you have an industrial building that was bought on a sale and lease back and let's say it had a 25, 30 year term on the sale and lease back a lot of these deals were cut

from 1967 to 1971-72. The accounting rules at that time required that you take the present value of the rent payments, treat them as though they were, in fact, an amortized level payment mortgage and create a liability from the liability side of the ledger equal to the present value of those future rent payments. Prior to that time you did not have to recognize more than one month of one year's rent on the books as a liability. At the same time, to offset that, you put onto the asset side the true value of the facility - whatever the cost is to buy the land, build the plant, put in the machinery, whatever else that had gone on. Because you were allowed to depreciate the asset as though you had bought it, and therefore on an accelerated basis, you ran the asset side of your ledger down very quickly. But the liability side was being run down just like an amortized mortgage in which most of it was interest in the first year and obviously, the large principal payments did not occur until later. So in effect, you were understating your surplus because your liabilities were out of kilter relative to your assets. Right? Furthermore you had to do that if you had a lease for longer than three years. If I had a corporation that needs a quick hit and a little juice to its earnings for this year, he can go in and say "gee," I'll tell you what I'm going to do - I'll buy that leasehold position from you for X dollars and re-lease the property to

you for 23 months, or 33 months, or 36 months, or whatever and give you the option to continue to renewing that to what would have been the end of the original 30 year term or whatever it was. And what that does is instantly take the asset off the asset side and the liability off the liability side. Since the liability is significantly larger than the asset, it drops right into surplus as earnings. Now Mr. Shidler is sitting in a position of a sandwich lease and he is now making the payments to whoever made the sale/leaseback in the first place and the guy that was in the property originally is now making rent payments to Mr. Shidler. Those rent payments undoubtedly in a deal cut in 1968-69-70 are significantly below the market rent for that space today. So his only risk is the guy doesn't renew at the end of three years, the reason for going into the deal was to escape the long term lease. All he has to do is worry about releasing the property at something greater than the rent which was left over from the olden days and he's home free, his cash flow is even better than it was before. Now he turns around and looks at the guy that owns the building, let's say it's otherwise a nice building, a good location, a relatively good structure, after he's owned it for a couple of years he thinks gee - this isn't a bad deal and there's 15 years to run on a lease that was set to yield 7 1/2%, to the insurance company at the time they made the

deal - which was not a bad deal in 1968. Now he goes around and says, "Gee - the leasehold value in this building is pretty substantial." Let's say it's a \$5.0 million warehouse, industrial type facility and currently gives him the present value of the rent stream to you to the end of the term, even assuming a resale price that's relatively favorable, is \$3.5 million. And I have a leasehold value of \$1.5 million because that's present value of the rental increment I can make over and above what I have to pay new. So I'll tell you what I'm going to do, I'll pay you \$4.0 million for it, you can reinvest the \$4.0 million and make up time by being able to invest at the current rate and I'm buying a building which has a \$5.0 million market value and reassembling the fee for a \$1.0 million less than market. And in most cases the seller would go through with that. He hasn't been able to extricate himself because the hit would have been too great. But the chances are good that he has already depreciated the property below the \$4.0 million mark so he's going to register a profit too. So the fee holder comes out with a capital gain less than he would have liked but at least he has his money back to reinvest at current rates which are more opportune. The tenant is out from under. He's just taken a little hit in the surplus to improve his earnings, he's happy and what's more he's improved his corporate flexibility, in that, he now has a

series of three year leases in which any time he wants to pick up and move or relocate or whatever, he can do that. He hasn't noticed Mr. Shidler in the meantime bought the leasehold out at less than it's value and now he buys the fee at less than its value (. . . tape problem) and given the fact that he bought the asset at less than market, he can effect finance out on the whole deal and never have a nickel of his own money in it. But notice he's playing the FASB rules on one side and he's playing the fact that the asset manager on the other side looks bad 'cause he got an asset of X dollars which is generating a rather miserable cash-on-cash yield and his investors let's say in pension funds, might want more cash-on-cash and _____ I'm not quite so anxious for the upside of property and realize there's no upside left on the property. They're much happier to get their cash out and reinvest at the current yield. So he looks better because he's improved his cash-on-cash yield, even though he's given away possible capital gains ten or fifteen years from now, everybody wins. It's totally engineered. _____ , just sold for \$4.0 million, therefore, that's market value, baloney. OK? So you have to look at the acquisition, how do I want to set it up? How do I want to set it up for tax purposes? How do I want it to look on the sellers books and notice if the seller doesn't work consistently with you, as Mark pointed out, Uncle Sam

smells "rat", he'll go back and unwrap the transaction on both sides and say, "Hey, he's treated as a capital gain and you treat it as a fee, what goes on here? Obviously, there must be a capital gain, so you can't write it off in three years, you're going to write it off over 27.5 years. You really have to make sure that doesn't occur. For example, one of the classic leaseback cases involved Minnesota Mining leasing a warehouse in Minneapolis and the developer came in, whom they had worked with before, wanted 100% financing on the deal, went to his friendly bank who was happy to do that. The bank said "All right, tell you what you're going to do. We'll make that a simple net lease for 3M and you assign us the full amount of the lease income until 100% of the financing on the warehouse has been amortized. Any time you want to step in buy down the mortgage or put some equity in, why then we'll restructure the deal and he can save on the capital. Now, the owner of the building, the developer, he depreciated the whole thing and deducted all of his payments to the lender as interest and took all of the payments from Minnesota Mining as rent. The IRS came in and said, "Wait a minute, nominally that lender who has title to the property as the security for his loan, he doesn't have any operating risk at all. Minnesota Mining has agreed to pay all of the operating, all of the maintenance costs, it's a triple net deal. The guy in the middle made his profit up

front - the construction fee and so forth, and the lender says, in effect, that while he has title you can have the property back any time you want to give him X dollars and make it an 80% loan again. So your deal with the lender really isn't wed to the lender at all. It doesn't match up. The lender has no ownership risk. Therefore, the lender ain't the owner, therefore the payments to the lender ain't rent. And indeed, the lender's books showed it as a mortgage loan. It didn't matter the fact that they were holding deed. As far as they were concerned, it was a straight mortgage deal - interest and principal. The developer, had in effect, deducting all his payments to the lender as rent. That didn't match up with their documentation as far as their in-house accounting was concerned. The deal was off and the lender had to go back and obviously pay taxes on the principal payments that he had been making to amortize the loan. You have to be confident in the acquisition that the seller is going to be treating the various dollars received in the same way as you are acknowledging them for your tax purposes as outlet. And that's part of the negotiations in the final folding. How each party will handle those elements.

The second element that you're going to be concerned with is timing - one element of timing is, of course, that's changed slightly is the fact that depreciation works on the

half year rule or the quarter year rule - if you buy real estate in the 7th month, you're allowed to depreciate it only for 6 months of that year. If you buy in the first half of the year, say in the first half of the year, you would be allowed 12 months depreciation on it. If you buy it in the last three months of the year, you're allowed only depreciation to 25% of what might have been possible on an annual basis. That's a change because in the old days, you could buy it on the 28th of December and depreciate it for the full fiscal year. So they chopped down on that. So now if you need a little extra kick early on, you may want to close part of the deal on December 28th which is the end of one calendar year and close the other part of the deal in the next fiscal year. So if you're limited to \$25,000 of tax losses, you get that to fall in two different tax years and you time your closing accordingly. By the same token, if you need to take the expenditures for certain elective items, you want to make sure you get them to fall in the tax year which has the income. There's an offset. One of the advantages of perhaps the so called convertible loan is that if a pension fund comes along and funds that shopping center while technically they may be willing to come in as a joint venture partner, put up 90% of the money and own the damn thing, their depreciation is going to get burned right up the chimney. They don't really need it, they're not

taxable. So by making it a convertible loan, the interest payments made to the lender which may be all the net income in the property, are totally deductible for the developer. He retains control and the depreciation such as it may be and the other tax investment credits and so forth as they may be, may all go to the developer or to his equity partner, depending on how he structures it. And then seven or eight years later, the lender has the right to call on the property and say, "OK, I'm going to take a 75% ownership position and forgive the debt, or I want my money back, it didn't turn out as well as you guys said and you're going to have to refinance it." But notice they've structured it by this deferred ownership position so that the tax benefits are going one direction and the income is going another direction. Another way to do that is split the ownership of the land and the building. One party that doesn't need shelter owns the land and takes land rent plus a participation and the other party owns the building and therefore is able to take the depreciation relative to his entity, but may get very little of the income during the depreciable phase of the project. So there's different ways to carve up the interest to provide 1) allocation of tax, income and capital gain benefits and 2) modify the timing as to when each party receives it. For example, with foreign capital, if it's structured right, there may be no capital

gains tax at all if you dissolve the total entity, sell of the whole thing and take your money home. As a result they may structure their deal largely as debt with a kicker of participation in the resale and then, in effect, simply liquidate the whole enterprise and take their profit home in the form of a one-lump liquidation dividend. And that was also possible in the old days for the American entity having a single 30 day liquidation obtain no double taxes on a corporate structure, but that's not possible any more. For foreign investors, it still is. So again, his timing and the character of the distribution is something that you want to build in up front. OK we'll stop for the moment. See you on Tuesday.