Buck the Tax Trends

written by HOWARD SHWIFF

Learn how to get strategic with tax planning and avoid the fleeting trends.

What do you get when you mix an accountant and an economist/real estate consultant? An article about taxing trends—specifically accrual and economic trends. I usually tell my clients, "We live in a cruel world, by which I mean in the world of accrual, by which I mean that we live in a world of economic expectations."

What Is Accrual?

Merriam-Webster's definition of accrual: "relating to or being a method of accounting that recognizes income when earned, and expenses when incurred, regardless of when cash is received or disbursed."

Future Accrual

Accrual also connotes taking into account today the logical expectations of financial events that have not yet occurred, but which we expect to occur because future events will logically follow the trend already established. For example, an apartment is leased and occupied, so a landlord expects the rent to be paid—but it's the 6th of the month, and the check is "in the mail." Nevertheless, the landlord accrues the income, and voila: he is richer, on paper.

I recommend to our property owner and small business owner clients to use QuickBooks, which can perform accounting both ways at the same time—cash basis and accrual basis. Recording a vendor's invoice accrues the expense; paying the invoice converts it to cash basis. Enter the rents owed for the month, and they're accrued; depositing the checks converts income receivable to cash revenue in the bank. Create payables by pre-spending receivables using your credit card(s). It can be a dizzying, cruel exercise to figure out where you are at any moment.

I suggest you accrue income before calling a mortgage broker so you can deliver an accrual basis P&L. After all, you expect payment any day; the tenant has promised to pay and has paid in the past, so the trend gives you the expectation and the accrued right to take that position in the loan application.

Real estate agents also accrue some future income in the "proforma" used to support the asking price. Say a couple units have been rented at current market rent, which is significantly higher than the actual rents in place. If an investor is patient, his expectations that the rents will increase will come true—logically, probably. The investor should expect to receive a 6% rate of return in time, even though the going-in rate of return is a 4% "cap rate." (I'm probably not accruing any goodwill with the brokerage community.)

For tax return purposes, check the box labeled "Cash Basis." That's almost always the most appropriate way to report for small businesses and small property owners. Except, you can deduct the credit card charges that recorded just before December 31, even though you have not paid the statement balance. Legitimate charges for year-end business purchases fall under the category of "Tax Planning" as long as you were not playing Santa Claus.

Let's flip to the economics of cap rates for a minute. Cap rates were 6-7% across the nation in the 70s and 80s. The real reason for the 4% cap rates today is the trend in government banking. The "Fed Funds Rate" has been going down a slippery slope for years, and if an investor cannot get a 2% yield from a government-backed bond, then a 4% return from apartments looks like the best game in town, for now. But the Fed Funds Rate is about to start going up after the election, and with it, cap rates.

Goodwill Accrual

Goodwill is a form of value accrual. Some additional value should accrue to a property because it has a reputation that is better than similar properties. In the future, a property's reputation (goodwill) should logically result in higher rents, higher occupancy, and better tenants who take better care of the property—which, in turn, decreases operating expenses.

Lenders, on the other hand, tend to ignore this future potential and thus remove accrued income and goodwill value. They prefer to value the property based on historical actual income and actual expenses. Thus, a tug-of-war ensues between historical actuals and accrued futures, and usually the appraiser ends up somewhere south of today's rent roll.

Accrual of Expenses

Accrual of expenses is when something hasn't been paid for yet, but it has been ordered, received, and installed. If the expense is accrued this year, the expense is deducted to lower taxable income and reduce income taxes. That's legitimate according to the IRS.

Expense accrual really gets cruel when you try to explain to an IRS auditor how the expense happened so you accrued it, but the payment never happened because the equipment didn't work and the contractor wouldn't replace it, so you never paid for it, and after he put a lien on the property, then you couldn't get a new loan, so you went bankrupt, and then you began accruing it as tax shelter for the rest of your life! Ever heard of anyone using that one before?

Demographics

The main overarching trend today is demographics—the age wave and income graphic illustrations of the population. The world, the United States, California—San Francisco in particular—is trending toward older empty nesters and their millennial chicks. People born during the age wave that began in 1946 are now 70 and older; they're stronger than ever and living longer than ever. So rent control landlords: beware. The older tenants aren't going anywhere any time soon.

When I was an apartment broker at TRI Commercial (and joined the SFAA), I would explain to prospective buyers that those rent controlled units with older tenants were valuable "diamonds in the rough"; just be patient, and the cash flow and property value would pop just as soon as the tenants vacated for senior living (a bit of a trend). But a lot of those older rent control tenants are still in occupancy, 25 years later. Moral of the story: Don't buy a 4 cap property expecting rapid rent increased and an 8% cash flow in a couple years.

Rents are pushed up by population trends, together with employment trends, especially construction employment. Construction workers come to town. They overbuild the skyline and leave, then rents plummet along with occupancy. Today we have a new trend: tech worker millennials and the construction workers building space to occupy them. And when they both leave, watch out. Millenium Tower won't be the only property sinking into the Bay.

Depreciations and Tax Regulation

You may have heard about a new method of depreciation called cost segregation and "UOP–Unit-of-Property" (a trend toward more complex tax regulations). Property owners are asking our accountants about UOP, but it's not worth mentioning unless you own several thousand high-rise units with all those trendy new amenity components, like solar hot water heating, LED lighting, a pet grooming salon, and a bank of elevators up to those 300-square-foot micro-units. (Who said trends have to make sense?)

Tax regulations are the trend of politics trying to strong arm the economy—like allowing more depreciation to accrue is supposed to attract more investment in real estate, and rental housing in particular. Why else would anyone take the risk of building 300-square-foot units in the Tenderloin that have to rent for $1,350 to break even? If you've ever tried to determine the economic logic behind our tax code, you know why I say it's a cruel world.

In fact, it's hard to find an expense line for running your apartments that's not under inflationary pressure. Property tax trends aren't looking pretty. Why aren't taxes 1% like the official San Francisco base tax rate? Well, just look at all the propositions and bonds we're voting on that get tacked on to our property tax bills: education, pollution control, rapid transit, and other forms of human welfare. The trend is inflation in the cost of every service we need and amenity we want from our city and county.

Which brings us to water. The Earth is awash with oceans of water. From the beginning of time, water has evaporated into the clear skies, and rained down upon the cool earth, and all was well everywhere. Has anyone suggested that global warming could have an effect on your property P&L? Just check out the cost of water charged to your property if you want to see inflation that nobody is talking about. And when the inevitable desalination plants come on line, you can bet the water will be a lot more expensive than the last trickle we take from the Tuolumne River.

The Best Trend

Our tax firm is seeing more 1031 tax deferral exchanges with creative strategies. Walgreens just gobbled up Rite Aid because baby boomers and millennials are gobbling down the meds. And how does the expansion of Walgreens get funded? With 1031 tax deferred exchanges. Sell your apartments at a 4 cap; buy a Walgreens at a 5% cap, based on a lease income guaranteed for 25 years by one big gorilla retail company that sells everything the big pharmas can produce; and finance it with a 3.5% interest rate loan. Retire to Hawaii and never receive another emergency toilet overflow call. That's the trend to jump on, if you ask me.

My pappy used to say, "Son, make your decisions based on your age, stage, and circumstances." Don't follow the herd or the hearsay; study the trends, but pay no attention to the expectations of others.

Howard Shwiff, is the Director of Real Estate and Business Advisory Services at Shwiff, Levy & Polo, LLP. He has 35 years of experience in the real estate industry, including property management, portfolio operations, property valuation, and brokerage (Licensed CA Real Estate Broker).