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# Real estate entities realize time and cost savings with tax basis approach

November 14, 2013 - Construction Design & Engineering

One of the many consequences of the financial crisis and sub-prime mortgage meltdown has been the rise of more stringent lender requirements. Audited financial statements are a typical financial reporting covenant for commercial properties. The standard language lenders often use in loan agreements requires the borrower to provide annual financial statements, audited or reviewed by an independent CPA, in accordance with Generally Accepted Accounting Principles (GAAP). Having this language in a loan agreement will require the real estate entity to use GAAP as a basis of accounting for financial statement purposes and the tax basis of accounting for federal and state tax filings. Utilization of GAAP will force the borrower to maintain two separate sets of records. Particularly for non-public small to medium sized entities, this can be very complex and costly.

Lenders will typically attempt to dictate the level of assurance to be provided by the accountant (audited, reviewed or compiled) as well as the basis of accounting used for reporting purposes. A borrower can negotiate both the level of assurance required (thereby possibly reducing the cost of the service required) and the basis of accounting used to report to the lender. The tax basis of accounting is defined as the basis of accounting that the reporting entity uses to file its income tax return for the period covered by the financial statements. The first and most obvious benefit of electing a tax basis presentation is the elimination of the need to maintain multiple sets of records. Since entities are already required to prepare tax reporting to comply with federal and state regulations, firms can capitalize on much of the preparatory work used in completing the tax returns. By presenting its financials on a tax basis of accounting real estate entities will be able to eliminate several complex GAAP measurement and disclosure requirements such as:

Impairment of long-lived assets - GAAP requires management to evaluate long-lived assets for impairment based on certain market indicators. If an impairment is noted it has to be charged to operations. This evaluation is not required when using a tax basis of accounting. Deductions only occur through depreciation charges and loss can be recognized only if the asset is sold.

Straight line rental revenue - Under GAAP rental revenue from long term leases (greater than one year) is recognized on a straight line basis over the lease term. This creates the need for tedious calculations especially when stepped rents and free rent periods are part of the lease agreement. Furthermore, straight line rental revenue does not always result in the most meaningful information for the financial statement users. If an income tax basis of accounting is used, rental revenue is recognized as billed to the tenants with no adjustment to include the effect of stepped rents or free rent periods, or as paid by the tenants if the cash basis has been selected for income tax reporting purposes.

Financial instruments - GAAP may require certain disclosures of the fair value of financial instruments; these disclosures are not necessary under the income tax basis.

Consolidation - Requirements may vary but in general they are simpler to interpret and apply under the tax basis of accounting.

In addition to these GAAP factors, the governing body for GAAP is reevaluating how long term leases are to be treated for accounting purposes. Although the issue is far from resolved, GAAP accounting may turn out to be even more challenging for real estate entities after this proposal is finalized.

There are many factors to consider when determining the acceptability of a special purpose framework (cash basis, tax basis, regulatory or contractual basis of accounting) versus GAAP. Most importantly, management ought to consider the financial information needs of the intended users, in most cases lenders and or investors. Real estate owners should discuss different reporting options with their accountants prior to entering into new lending agreements. Accountants are a valuable resource in this process and can aide in the discussion with lenders on financial reporting covenants. Since considerable cost and time savings result by using a special purpose framework such as tax basis, it is important that owners pay particular attention to this before being locked into tedious reporting requirements.

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