



Understanding Resale

By Frank Gallinelli

One topic that often gets less attention than it deserves from real estate investors, however, is resale. Some tend to be dismissive, looking at resale as speculation, but many others simply find it difficult to focus seriously on the matter of selling a property they haven't yet purchased.

It may take a little extra discipline to work a consideration of resale into your investment mindset, but it is just such discipline that often separates the successful investor from the sorry.

You care about the potential cash flow, the financing, the operating costs and the tax benefits. You had better care also about whether the property will be saleable after you buy it. Often one hears, "Yes, but I plan to keep it for 15 years, or until my toddlers graduate from med school, or until the Federal Reserve Board dances figure-eights on ice with the devil."

That's fine; may all your plans go without a hitch. But what if you need to sell this property next year? What if a better opportunity comes along in five years, and you want to cash out? Recite this mantra whenever you consider purchasing an income property: If it's not worth selling, then it's not worth buying.

The world may not be perfect, but at least it's flat – flat, as in "level playing field." You can reasonably assume that if you would scrutinize a property's income, operating expenses, financing and various measures of return before you purchase, then tomorrow some equally astute investor will apply a similarly jaundiced eye to your numbers if you choose to sell. It pays, therefore, to run tomorrow's numbers today, and to see just what this investment will look like to a future buyer.

So, what are the numbers that should concern you when you analyze the potential resale of an income property? The most obvious, and the most important, is the selling price. If you have followed our earlier articles, you know that with most income properties, you can estimate the value by applying a reasonable capitalization rate to the net operating income. (If you have not read the articles, you will get surely get more out of this discussion if you go back and read them first. Their links are [Understanding Net Operating Income](#) and [How to Estimate Resale Value - Using "Cap" Rates](#).)

In brief, you first determine the property's Net Operating Income (NOI). Next you must estimate the capitalization rate (i.e., the rate of return) that the buyer would reasonably expect. The NOI is the amount of the return and the cap rate is the rate of return. Hence, if the market expects a 10% return and your property produces a NOI of \$12,000, your estimate of its selling price would be \$120,000. Another way of articulating the algebra involved is to say, "\$12,000 represents 10% of what?"

A curious phenomenon exists in the real world. Buyers and sellers can look at the same information and see different meanings. This, I suspect, is the closest that commercial real estate will ever come to poetry. Not only might you have a different notion of "reasonable rate of return" as a seller, you might also change your perspective on NOI. It is common for a buyer to estimate value by capitalizing the current year's NOI, and for a seller to capitalize next year's expected NOI. The buyer typically takes the position, "I am buying the income stream that just happened, and the property's value is based on that income stream. If the income goes up next year, that's my business." The seller, as a rule, will assert, "You didn't own the building last year. You're buying next year's higher income stream. The value of what you're buying should be based on that."

You decide.

Once you develop your estimate of the resale price, the rest of the analysis of resale is fairly straightforward. You will need to calculate the estimated tax liability at the time of sale. Then, with that number in hand you can project the sales proceeds and the overall rate of return for the holding period.

If you use RealData®'s Real Estate Investment Analysis, V12.0, you will have all of these calculations done for you. Equally important, the program will test a potential resale each year for up to 10 years, allowing you to identify an optimum holding period. Let's look at just the first four years of such an analysis.

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Our first task is to figure the gain. We do this by taking the selling price and subtracting from it the property's Adjusted Basis.

	1999	2000	2001	2002
PROPOSED SELLING PRICE, NET OF COSTS	1,204,243	1,204,258	1,137,801	1,268,891
Selling Price (Based on Cap Rate Based Value of 12.00%)				
INTERNAL GAINS, Purchase Price at Basis (Sale)	690,000	570,000	580,000	690,000
Less: Real Estate Agent's Commission (3.0% Exchange)				
+ Proceeds Closing Costs, Assessor	8,000	8,000	8,000	8,000
+ Cumulative Capital Improvements and Transactions	138,000	138,000	222,000	252,000
+ Costs of Sale	7,000	7,000	8,000	8,000
- Adjusted Cumulative Depreciation, Real Estate	44,500	31,500	47,000	84,000
- Adjusted Cumulative Depreciation, Capital Assets	200	800	1,000	1,200
- Adjusted Cumulative Depreciation, Tangible Intangible	2,200	2,200	3,000	3,600
- Cumulative Amortization, Basis	0	0	0	0
ADJUSTED BASIS AT SALE	1,083,400	1,093,200	1,108,200	1,177,800

What is the Adjusted Basis? It is the property's original cost, plus capital improvements, plus closing costs and costs of sale, less accumulated depreciation. Essentially the Adjusted Basis is what you spent to purchase, improve and sell the property, less the amount you have already written off. If you sell the property for more than this amount, you have a taxable gain.

	1999	2000	2001	2002
GAIN OR LOSS ON SALE, Real Estate	120,843	111,058	329,601	109,091

In calculating your tax liability at the time of sale, there are certain deductions that may come into play. For example, you may have had operating losses in prior years that you were not allowed to take because they exceeded your "passive loss allowance." If you could not deduct them earlier, you can deduct them at the time of sale. You may also have had loan points and leasing commissions that you were amortizing (i.e., deducting over time). If you have an unamortized balance on these items, you can deduct it when you sell.

	1999	2000	2001	2002
DEDUCTIONS AT SALE				
Suspended Losses (Operating Loss)	0	0	0	0
Unamortized Loan Points	41,275	11,400	16,700	16,700
Unamortized Leasing Commissions	0	11,200	14,900	14,200
TOTAL DEDUCTIONS AT SALE	41,275	22,600	31,600	30,900

Now you have enough information to compute the tax liability due on sale. (If you have not done so, you may want to read our article on the new capital gains tax for a discussion of how the tax is calculated).

	1999	2000	2001	2002
TOTAL FEDERAL TAX LIABILITY	14,875	27,200	3,000	14,200

No doubt your greatest concern is the amount of cash you will realize from the sale. To determine that figure you must take the selling price, subtract the costs of sale (such as legal fees and sales commissions), subtract the outstanding balances of all mortgages and add back any unused funds left over in your reserve account. Now you have your Before-Tax Sale Proceeds. Subtract the Federal tax liability and you have the After-Tax Sale Proceeds.

	1999	2000	2001	2002
PROPOSED SELLING PRICE, NET OF COSTS	1,204,243	1,204,258	1,137,801	1,268,891
- Costs of Sale	7,000	7,000	8,000	8,000
- First Mortgage Payoff	620,800	610,400	598,000	498,000
- Second Mortgage Payoff	81,000	81,000	81,000	81,000
- Third Mortgage Payoff	81,000	81,000	81,000	81,000
- Refinance Payoff	0	0	0	0
+ Balance of Reserve Fund	10,800	10,800	5,700	6,300
BEFORE-TAX SALE PROCEEDS	395,243	406,658	396,501	596,191
- Total Federal Tax Liability	14,875	27,200	3,000	14,200
AFTER-TAX SALE PROCEEDS	380,368	379,458	393,501	581,991

The timing as well as the amount of your resale are important to your overall return. In this example, the software is computing that overall return for different holding periods and you can see that the timing can make a substantial difference.

	1999	2000	2001	2002
Internal Rate of Return, Before Tax	8.81%	9.46%	14.13%	16.03%
Adjusted Internal Rate of Return, Before Tax	8.81%	9.46%	14.13%	16.03%
Internal Rate of Return, After Tax	8.47%	9.24%	13.07%	15.43%
Adjusted Internal Rate of Return, After Tax	8.47%	9.24%	13.07%	15.43%
PI, Not Accounting for Sale & Refinance	1,177,213	1,214,257	1,207,213	1,200,200
PI(PI), including reserves	414,107	447,252	506,202	691,200
Internal Rate of Return (PI/PI)	35.29%	36.97%	41.93%	57.13%

Internal Rate of Return (IRR) is one of the most commonly used methods of measuring the quality of a real estate investment. Others include Present Value, Return on Equity, Cash-on-Cash Return and Debt Coverage Ratio. Some of these measures are fairly sophisticated, while others are quite simple. In our next article, we will take a closer look at some of these ways of measuring the success of your investment.