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Taxes and Real Estate: Some Considerations

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For most real estate-intensive restaurant companies, leasing real estate is preferred to ownership. Leasing can lower their cost of capital, create greater shareholder wealth and enhance corporate flexibility relative to other financing options.

But, what if the sale of real estate triggers a material tax consequence? This can be especially true for companies and individuals that've held their real estate for a long time during which they substantially depreciated the improvements. For individuals (which includes S-Corporations and LLC's), the "recapture" of depreciation is taxed as ordinary income. The highest personal marginal federal tax rate is currently 39.6%, which will certainly take a bite out of the proceeds. For C-Corporations, where all income is treated equally, the rate most commonly used is 35%, which is also punitive.

Summary State Tax Facts	Personal	Corporate
Average Rate For States With Taxes	*6.6%*	7.3%
Maximum Rate	*12.3%*	12.0%
States with Taxes	*42*	45
States With No Taxes	*9*	6

With state taxes the bite just gets bigger, unless you are fortunate to live in one of the few states having no personal or corporate income taxes. Add the state taxes to the federal taxes and we are talking about average marginal tax rates in the area of 46% for individuals and 42% for corporations. And the average can get much worse, especially if you happen to live in California or Iowa, which have the nation's highest personal and corporate tax rates.

Tax leakage from real estate sales can cause a reevaluation of the merits of selling real estate. A summary financial model using the highest marginal tax rates can best illustrate this:

Model Inputs		Model Output	
Corporation Type	*LLC*	Effective After tax Lease Rate	9.74%
State Tax Rate	*Average*	Added Cost Over Pre-Tax Lease rate	2.24%
Unit Level Lease Coverage (1)	*2.0*	Pre-Tax Proceeds R.E. Multiple	6.67X
Initial Lease Rate	*7.5%*	After-Tax Proceeds R.E. Multiple	5.13X
Land Portion of Value	*20.0%*	After Tax Multiple Lost	1.53X
% Gain(Loss) Over Cost (2)	*10.0%*		
% Improvements Depreciated	*60%*	% of Proceeds Lost	22.98%

1. The ratio of store-level EBITDAR to Rents
2. Gain spread evenly over land, building and improvements

Using a fairly typical company illustration, and adding a modest capital gain of 10%, the amount lost to taxes is almost 23% of proceeds, or more than 1.5x EBITDA. In this illustration, in addition to federal tax on recapture, there are also federal taxes on the 10% of capital gains, which includes the new 3.8% Net Investment Income Tax.

The pre-tax lease rate may be 7.5%, but with the nearly 23% in tax leakage, the after-tax lease rate escalates to nearly 10% (this is computed by dividing the annual rents into the after-tax proceeds).

The tax impact is material and can rightly cause one to question the wisdom of selling real estate given such punitive charges. A tax trap like this is not uncommon across businesses from small to large and can have varying implications as illustrated below:

% Proceeds Due To Tax Leakage[1]					
	40%	50%	60%	70%	80%
Highest Marginal Corporate Tax Rate 35%	11.2%	14.0%	16.8%	19.6%	22.4%
Highest Marginal Personal Fed Tax Rate 39.6%	12.7%	15.8%	19.0%	22.2%	25.3%
Average All-in Highest Corporate Rate 42.3%	13.5%	16.9%	20.3%	23.7%	27.1%
Average All-in Highest Personal Rate 46.2%	14.7%	18.5%	22.2%	25.8%	29.5%

1. to simplify this illustration, tax leakage excludes capital gains taxes.

So, what can be done to avoid being a victim of a tax trap that can result in electing sub-optimal financing options?

There is a range of choices, but the important thing to remember is business leaders should take charge of their own tax issues. That means addressing tax issues before ever considering selling a business, because prospective buyers tend not to show up with the answers.

In this regard, it is important to mention that selling real estate in advance of a business sale will generally not detract from corporate valuations. In fact, most financial sponsors and other sophisticated investors tend not to want to own real estate anyway and will sell it off concurrent with an acquisition. Therefore, if forward tax planning is effective, the after-tax value of a business can be greatly enhanced.

As noted in the initial model, the value of this profit-center real estate equates to a pre-tax EBITDA multiple of 6.67x. However, this is not the value of the whole enterprise, because companies that lease all of their real estate are often sold for EBITDA multiples ranging from 4x to 6x. At a 5x business multiple, the effective total pre-tax EBITDA multiple, inclusive of the value of the profit center real estate, increases to 9.17x as illustrated below.

Corporate Valuation Summary:	
1. *Leased Cash Flow Purchase Multiple*	*5.00X*
2. *Unit-Level Rent Coverage*	*2.00X*
Total Business and Real Estate Valuation	
3. *EBITDAR/Real Estate Proceeds (4 X 2)*	*15.0%*
4. *Initial Lease Rate*	*7.5%*
5. *EBITDA/Real Estate Proceeds (3-4)*	*7.5%*
6. *Post Rent Value/Real Estate Proceeds (5 X 1)*	*37.5%*
7. *Total Value/Real Estate Proceeds (100%+ 5)*	*137.5%*
8. *Real Estate EBITDA Multiple (100%/3)*	*6.67X*
Total EBITDA Multiple (7 X 8)	*9.17X*

What are some of the choices business leaders can make to increase the after-tax values of their businesses? It will depend upon their objectives. For example, is the objective to realize cash proceeds or to diversify holdings into assets of equivalent value?

To maximize cash proceeds, options range from selling property companies (the stock in a property company, rather than the underlying real estate) to real estate retention using various mortgage, participating mortgage or hybrid mortgage options.

If the objective is to realize in-kind valuations, 1031 real estate exchanges or real estate investment trust UPREIT operating partnership unit exchanges are two of many options. In selecting a path, it will generally be important to simultaneously work with tax advisors and also with the capital sources in the lease drafting process.

Tax traps are commonplace. However, with some planning, business leaders can minimize their impact in order to better optimize the after-tax valuations of their businesses. Creating a successful business is very hard work. Preserving that value entails, among many things, being attentive to tax considerations. This is especially true for the leaders of real estate-intensive businesses.

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