SNAPSHOT REVIEW: UNIT TWELVE

ANALYSIS OF CAPITAL GAIN AND CASH FLOW

KEY TERMS

- Depreciation allows owner of income property to deduct a portion of property's value from gross income each year over life of asset
- Basis is cost of a capital asset at a point in time
- Depreciable bases is undepreciated improvement portion of the property
- As property is depreciated, or new capital improvements are added, basis is adjusted accordingly and becomes a new adjusted basis
- If real estate sale proceeds exceed original cost, there is capital gain that is subject to tax
- If sale proceeds are less than original cost with adjustments, there is a capital loss
- An expense incurred by an income property that was paid to keep property operating and maintained is a tax deductible expense
- Taxable income from investment real estate is gross income received minus any expenses, deductions or exclusions that current tax law allows

CAPITAL GAIN ANALYSIS

- Capital gain on sale of property equal to amount from sale minus adjusted basis of home sold

Amount realized

- Net proceeds from sale
- Sale price - costs of sale = amount realized

Adjusted basis

- Beginning basis (amount invested in property) is increased or decreased by certain types of expenditures made while property is owned
- Beginning basis + capital improvements – depreciation = adjusted basis

Gain on sale

- Amount realized (net sales proceeds) – adjusted basis = gain on sale

INCOME PROPERTY CASH FLOW ANALYSIS

Steps in the cash flow analysis

- Identify pre-tax cash flow
- Identify tax liability
- Derive after-tax cash flow

Pre-tax cash flow Cash flow before taxation

	potential rental income
-	vacancy and collection loss
=	effective rental income
+	other income
=	gross operating income
-	operating expenses
-	reserves
=	net operating income (NOI)
-	debt service
=	pre-tax cash flow

Tax liability

- Based on taxable income rather than cash flow
- Taxable income multiplied by owner's marginal tax bracket is tax liability

After-tax cash flow

- Amount of income from property that actually goes into owner's pocket after income tax is paid

Applying the analysis to investments

- Essential for investors to understand property's yield in relation to its value or price

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Check Your Understanding Quiz:

Unit Twelve: Analysis of Capital Gain and Cash Flow

Carefully read each question then provide your best answer based on what you learned in this unit. Then check your answers against the Answer Key which immediately follows the quiz questions.

1. What is the name of an addition to a property that augments the property's value?

   a. Capital improvement
   b. Capital gain
   c. Appreciating basis
   d. Improvement basis

2. How do you calculate rate of return?

   a. Multiply the income by the price.
   b. Add the capital gains to the income.
   c. Divide the income by the price.
   d. Subtract the expenses from the net profit.

3. ________ is a measurement of how much is invested in the property for tax purposes.

   a. Growth
   b. Appreciation
   c. Gain
   d. Basis

4. What is the first step cash flow analysis?

   a. Identifying the tax liability
   b. Deriving the after-tax cash flow
   c. Identifying the potential and effective income
   d. Calculating the operating expenses

5. The net proceeds from a sale are also called the ___________.

   a. amount realized.
   b. capital gains.
   c. gross profit.
   d. grown basis.

6. Which portion of real estate is depreciable?

   a. Land portion of real property
   b. Improvements on property
   c. Both the land and the improvements made on the property
   d. No portion of real estate is depreciable.

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Answer Key:

Unit Twelve: Analysis of Capital Gain and Cash Flow

1. a. **Capital improvement**
2. **c. Divide the income by the price.**
3. **d. Basis**
4. **c. Identifying the potential and effective income**
5. **a. amount realized**.
6. **b. Improvements on property**