Alternative Financial Reporting Option for Real Estate Companies

GAAP vs. Tax Basis Financial Statements

Independently audited financial statements are vital to the efficient and effective operation of capital markets in the United States. In a world characterized by asymmetrical information between providers and users of financial data, auditors fill the gap in the middle, providing reasonable assurance that the financial information asserted by management is free of material misstatement, and as such, can be relied upon by financial statement users in the decision making process.

Generally Accepted Accounting Principles (GAAP) is currently the most common reporting standard for financial statements in the United States. However, GAAP continues to become more and more complex, and in many instances its metrics for measuring financial performance are becoming further separated from those used by owners, investors and operators of real estate assets. In an industry where tax impacts are a significant driving force in decision making, we have seen a rise in recent years in the use of tax basis financial statements. The intent of our article is to highlight some of the major areas where Income Tax basis financials deviate from GAAP basis financials, and where our clients find the added benefits of adopting this other basis of accounting for financial reporting.

Often times, audited financial statements are a requirement imposed by agreements with financing sources. These agreements tend to have boiler plate terminology requiring that financial statements be prepared in accordance with GAAP. More and more, these financing sources are accepting tax basis financial statements in place of those prepared in accordance with GAAP. The change to an Income Tax basis financial would first need to be approved by the user of the financial statements. Once approved, owners and operators may find that this new reporting methodology yields a more valuable financial tool with more relevant information for making decisions.

Depreciation Differences

GAAP requires that fixed assets be capitalized and depreciated over their useful life, using a reasonable method that matches an asset’s use. This creates the necessity for management to assess and reassess the remaining useful life and methods used for depreciating an asset. Continual reassessment may lead an owner to determine that, for example, because of deferred maintenance or certain enhancements, the asset’s life could be shorter or longer than initially estimated. Changes in depreciation lives and methods create disclosure and other considerations in a GAAP basis financial.

The tax basis of accounting eliminates the need for this exercise. Asset lives and allowable methods are set by the IRS, leaving little discretion in what is used. These depreciation differences commonly result in some of the biggest dollar value adjustments when arriving at an entity’s taxable income. Additionally,
these depreciation differences create inherent differences in the carrying value of assets for purposes of projecting gains and related depreciation recapture on sale. Since the depreciation deduction is one of the biggest tax advantages of real estate investment, adopting the tax basis of accounting will allow management to immediately quantify the current tax depreciation deduction as well as the tax basis of the asset for purposes of easily estimating taxable gains on sale. Further, you will eliminate the need for continual reassessment of lives and depreciation methods over the asset life.

**Capitalization Differences**
Currently, within the industry itself, there is a wide range of approaches regarding how certain replacement items are treated with respect to capitalization versus a current period charge to expense. In a GAAP audit, this is far less of an issue because much of the auditor’s assessment of recurring replacement type items (such as carpeting) trend back to compliance with the Organization’s accounting capitalization policy. The same approach does not necessarily hold true for preparation of income tax returns, and recently proposed Treasury Regulations may continue to widen the divide in how certain costs are captured for GAAP financial reporting versus income tax reporting. In many respects this new regulation, if adopted in its current form, will have dramatic impacts on the way owners approach and schedule repair and maintenance efforts. This regulation may create significant differences between GAAP and income tax reporting of expenses.

Tracking these differences may be difficult, and would, at a minimum, create a need for multiple depreciation calculations for every asset. Additionally, these differences would only continue to complicate the exercise management must go through to understand the tax basis of assets in a sale scenario. Adopting the income tax basis would allow owners to alleviate the burden in tracking these differences, and similar to the depreciation methods, it would allow for a readily available figure for which to estimate taxable gains in a resulting sale or restructure.

**Rental Income Recognition**
Currently, GAAP stipulates that rental income is recognized evenly over the life of the lease. Commercial leases commonly include rent abatements or holidays in addition to escalation clauses. The financial impact of these aspects of lease negotiation is often lost when reported under GAAP by virtue of this straight-line approach. A trained individual may be able to recognize the cash flow impacts of these negotiations in the statement of cash flow, but not necessarily by examining the statement of income – which is often the main financial statement analyzed.

The tax basis of accounting focuses much more on actual rent charges (and receipts in the case of advance rent payments) during the tax period. As a result, there are often significant adjustments to

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GAAP rental revenue when deriving tax basis revenue. Adopting a tax basis method of accounting would allow management to more readily measure its tax basis revenue for purposes of tax planning and strategy, not to mention the impacts of negotiated lease incentives that occurred during the year.

**Basis Adjustments Under Section 754**

Assets held for rental operations are generally reported at their historical cost basis, net of impairment and depreciation under GAAP. Unless control of the asset is changed, there is no reflection of increases in asset value as a result of appreciation over time. Control can generally be defined in GAAP as a 50% or more change in ownership.

A partnership can elect under Internal Revenue Code Section 754 to adjust the basis of partnership property in the event of a transfer of partnership interest through sale or exchange. In general, the partnership increases the basis in its assets by the amount of the excess of the price paid over the transferee’s share of the partnership property’s basis. The adjustment is specific to the new partner interest only and does not increase the basis of the property with respect to any other partner. The election applies to all transfers that take place during the current and all subsequent tax years. The election can also cause a decrease in the basis of property.

**Variable Interest Entity Consolidation Requirements**

It is commonly understood that GAAP accounting standards require consolidation if an entity preparing financial statements has a controlling financial interest in another entity – typically defined as a majority interest. More difficult to apply are the GAAP requirements for consolidation of Variable Interest Entities (VIEs). Identification, analysis and the resulting accounting for consolidation of VIEs is difficult, time intensive and widely open to judgment and perception of relationships among entities.

Certain contractual relationships, such as loan guarantees or collateralizations, can easily lead to a VIE designation and resulting consolidation requirement for entities not even owned by the reporting entity. Consolidation under tax reporting is more straightforward. Entities formed as partnerships would not be consolidated unless only one owner exists as in the case of a limited liability company. For groups that regularly deal with this VIE consolidation issue, converting to an income tax basis of reporting can save hours of analysis time and meetings with auditors, and may potentially result in lower audit fees as a result of reducing the complexity of the audit itself.

**Impairment Analysis**

The tax basis of accounting does not follow suit with GAAP regarding assessing and measuring assets for impairment. Under GAAP, management would be required to assess a building for impairment if there are indicators it is impaired. Indicators could include declining occupancy rates, poor coverage ratios, or declining operating cash flows. A commonly used approach involves management (or an appraiser’s)
projections of cash flows for the period the asset is expected to be held plus an estimate of the sales price of the asset at the end of that time period. In the past several years, many owners have found themselves dealing with auditors on this subject for assets that are underperforming at the current time, undoubtedly because of the unique economic times our country is facing. Not only are these projections time consuming for management to prepare and sometimes costly when employing an outside appraiser, but defending these projections to auditors can be difficult given the market’s performance over the past several years.

The income tax basis of accounting mitigates the need for this formal assessment entirely. Assets are generally carried at historical cost and impairment write downs for projected declines in value are not allowable. Write downs or losses are generally only recognized upon the sale of the real estate asset, thereby eliminating the need for continuous impairment analysis.

**Are Tax Basis Financial Statements Right for My Company? Items for Consideration Prior to Changing Your Method of Financial Reporting:**

- Intentions to sell a business – If owners intend to sell their business in the near future, it is important to consider the financial reporting preferences and requirements of all parties to be involved in the sale.

- Contractual requirements and loan covenants – there may be a requirement that a specific basis of accounting be used in preparation of an entity’s financial statements, but this requirement is increasingly open for negotiation and borrowers should discuss the possibilities with their lenders.

- The tax basis of accounting may more closely resemble the cash basis of accounting. As a result, it may cause larger variations in income from one year to the next depending on cash flow results.

- If comparative financial statements are presented, a conversion in your method of accounting may require the restatement of prior year balances to allow for year over year comparability. The necessity for prior year restatements may have an increased effect on preparation cost in the initial year of conversion. However, preparation costs would likely decrease in subsequent periods.

**Management Perspective**

We understand from our experience that some of the primary financial considerations for the real estate industry center around cash flow analysis and tax implications of decisions made or to be made. These considerations affect the timing of maintenance efforts, decisions to sell or acquire, and negotiations and
structuring of leases among other things. Recently available tax deductions have provided significant increases in our client’s return on investment that simply cannot be captured in GAAP basis financials. Moving toward an income tax basis method of accounting can help to show these benefits to investors and owners with the added assurance of an auditor’s report, not to mention provide an easily accessible tool that decision makers can actively use.

For further information, please contact your Dixon Hughes Goodman tax advisor or Rick White, Partner, at 703.226.0098 or rick.white@dhgllp.com.

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