

Real Estate Terms Definitions

ABATEMENT - In a lease, the reduction or elimination of rent for a period of time. For example, as an inducement to a tenant to rent a particular space, the landlord may abate the rent for a period of months while the tenant remodels the space.

ACCELERATED DEPRECIATION - Depreciation methods that allow a taxpayer to take faster write-offs than with straight-line during the early part of an asset's useful life.

ACCUMULATED DEPRECIATION - The sum of annual depreciation deductions taken to date. Also, accrued depreciation.

ADJUSTABLE RATE MORTGAGE (ARM) - A mortgage loan in which the interest rate is not constant over the life of the loan, but is adjusted periodically according to a predetermined formula or index.

ADJUSTED BASIS - The original cost of an asset, such as real estate, plus capital improvements, less accumulated depreciation and costs of sale. The taxable gain at the time of sale is, in general, the selling price less the adjusted basis.

ADJUSTED GROSS INCOME (AGI) - Gross income less certain adjustments, including IRA, alimony and Keogh deductions. Used to determine the investor's passive loss allowance, which begins to phase out when the investor's AGI reaches \$100,000 and is completely eliminated at \$150,000.

ALTERNATIVE MINIMUM TAX (AMT) - A tax that may be triggered if certain tax benefits, such as passive losses and accelerated depreciation, reduce an individual's income tax liability. You must use Federal tax form 6251 to determine if you are subject to the Alternative Minimum Tax.

AMORTIZATION - a) The process through which a loan is retired over time through periodic repayment of the principal. b) The process of taking a partial annual tax deduction for an item that cannot be expensed in a single year. For example, points paid to secure a loan must typically be deducted (amortized) over the life of that loan.

ANNUAL DEBT SERVICE (ADS) - The total of all payments on a mortgage loan, including both interest and principal, for a year.

ANNUAL PROPERTY OPERATING DATA (APOD) - A form that lists a property's gross income, individual operating expenses and net operating income. An APOD is similar to a business profit-and-loss statement.

APPRECIATION - The increase over time in the value of an asset due to economic factors rather than to improvements or additions.

ASSUMED MORTGAGE - A mortgage in which the purchaser of a property assumes liability for payment of an existing mortgage loan. Typically the purchaser takes over the

existing balance, terms and payment schedule. Many mortgage loans contain a “due on sale” clause which prohibits assumption by requiring the original borrower to pay off the loan if he or she transfers title of the mortgaged property to a third party.

AT-RISK RULES - A provision in the tax code that limits deductions for losses to the amount “at risk,” i.e., to the cash invested plus the amount of notes for which the investor is personally liable. However, the tax code also provides for certain non-recourse real estate loans to be treated as if they were “at risk.”

BALLOON - A provision in a loan that requires the principal balance to be paid off in a lump sum before the loan would be retired through normal amortization. For example, a loan may be written with a fifteen-year amortization and a seven-year balloon. The periodic payment amount and the interest and principal portion of each payment are all calculated as if the loan were to run for fifteen years. However, the borrower would retire the loan at the end of seven years by paying the balance outstanding (the balloon) at that time. Also, Balloon Payment.

BASIS - The starting point for computing gain or loss on an investment; typically, the original purchase price. See also, Adjusted Basis.

BOOK VALUE - An asset’s original basis less accumulated depreciation.

CAPITAL ADDITION - An addition to a piece of real estate having a useful life of more than one year, or an improvement that is likely to prolong the life of the property. A capital addition is different from a repair, which maintains rather than increases the life of a property.

CAPITAL GAIN - Gain from the sale or disposition of a capital asset, such as real estate. May be long term or short term.

CAPITAL IMPROVEMENT - See Capital Addition.

CAPITALIZATION RATE - The ratio between a property’s Net Operating Income and the sum of its purchase price or value. It is a measure of return before consideration of taxes, financing or recovery of capital. If a property has a given NOI, then the higher the capitalization rate demanded by an investor, the lower the value of the property. Also called “cap rate.”

CASH DISTRIBUTION - The disbursement of a portion of property’s cash flow to a partner.

CASH FLOW AFTER TAXES (CFAT) - The cash flow before taxes, reduced by the tax liability that the property generates for the owner, or increased by the tax savings.

CASH FLOW BEFORE TAXES (CFBT) - During a given period, all of a property’s cash inflows less all of its cash outflows. Inflows are counted whether or not they must be included as taxable income and outflows are counted regardless of deductibility. For example, cash flow is affected by the entire amount of a mortgage payment, even though

only the interest portion is deductible. Cash flow is not affected by a depreciation deduction, which is not a cash item. “Cash flow before taxes” ignores the property’s effects on the owner’s income tax liability.

CASH-ON-CASH RETURN - The rate of return on an investment measured as the ratio between the cash flow before taxes and the initial cash investment.

CLOSING COSTS - Costs paid, typically to an attorney, for documentation and representation in connection with the purchase or sale of a piece of real estate. Title insurance is usually considered a closing cost, but real estate commissions, loan fees, prepaid interest and fire or liability insurance are not considered closing costs.

COMMERCIAL PROPERTY - See Non-Residential Property.

COMMISSION - A fee paid, typically to a real estate agent or broker, for negotiating a loan, lease or sale.

COMPARABLES - For purposes of valuation, properties that are similar to the subject property and that have been recently sold or leased.

CONSUMER PRICE INDEX (CPI) - An index published by the U. S. Bureau of Labor Statistics and widely used as a measure of inflation. The index estimates the cost of buying a fixed group of goods and services and compares that cost to the base year (1982) that was assigned an index value of 100. The CPI is commonly used in escalation clauses of commercial real estate leases so that the rent generated by those leases will keep pace with inflation. Also, cost-of-living index.

COSTS OF SALE - Fees typically paid to a broker and/or attorney to effect the sale of a piece of real estate. These costs are not tax deductions as such. Rather, they are an adjustment to the basis of the property.

DEBT COVERAGE RATIO - The ratio between the annual net operating income and the annual debt service. Most lenders require a debt coverage ratio of at least 1.2. A property with a 1.2 debt coverage ratio has income before debt service that is 1.2 times as much as the debt service—in other words, the property generates 20 percent more net income than it needs to make its mortgage payments.

DEBT SERVICE - The total loan payment, including both interest and principal.

DEPRECIATION - Used interchangeably with “Depreciation Allowance.” Appraisers, however, typically use the term “depreciation” to represent the actual loss in value due to physical wear and tear and to functional and economic obsolescence.

DEPRECIATION ALLOWANCE - The amount of the tax deduction that a property owner may take each year until he or she has written off the entire depreciable asset. In real estate, the physical structures are considered depreciable assets, but the land is not. Therefore, there is no depreciation allowance for the value of the land. See also Useful Life.

DISCOUNT RATE – The compound interest rate used to reduce expected future cash flows to their estimated present value.

DISCOUNTED CASH FLOW ANALYSIS (DCF) - An income-property appraisal technique that estimates value by discounting all expected future cash flows to the present and summing the discounted amounts.

EFFECTIVE GROSS INCOME (EGI) - See Gross Operating Income.

ESCALATION – A clause in a real estate lease that provides for an adjustment to the rent, usually based on some external event, such as a rise in the Consumer Price Index (CPI).

EQUITY - The difference between a property's value and the balance of the debt against it. A property worth \$1,000,000 with loans totaling \$750,000 has equity of \$250,000.

EXPENSE STOP - A provision in a lease where the tenant agrees to pay the excess of certain operating expenses over a base amount. The landlord pays the expense up to the amount of the expense stop and the tenant pays or reimburses the landlord for the rest.

FAIR MARKET VALUE - The price at which a property would change hands from a willing seller to a willing buyer, where neither party is under a compulsion to sell or buy and where both have reasonable knowledge of all pertinent facts. Also, Market Value.

FIRST MORTGAGE - The first, or senior claim against an asset, as security for repayment of a debt.

FUNDED RESERVES - A sum of money put aside so that it will be available to handle an extraordinary expense or improvement. For example, an investor may anticipate the need for a new roof five years after acquisition of a property and place money into a reserve account in advance so that funds are available when needed.

GENERAL PARTNER (GP) - The person or entity in a limited partnership that bears unlimited liability and all of the management responsibility of that partnership.

GROSS OPERATING INCOME (GOI) - A property's annual Gross Scheduled Income, less allowances for vacancy and credit loss. Also, Effective Gross Income.

GROSS RENT MULTIPLIER (GRM) - A method of estimating or expressing a property's value as a multiple of its gross rental income. Also, Gross Income Multiplier.

GROSS SCHEDULED INCOME - The annual income of a property if all rentable space were in fact rented and all rent collected; the total potential income.

HALF-MONTH CONVENTION - A provision of the tax code as of this writing that allows only one-half month of depreciation in the month a property is acquired and one-half month in the month it is sold.

IMPROVEMENT - See Capital Addition.

INCOME PROPERTY - Real property leased to tenants and held for the purpose of generating ongoing rental income.

INFLATION - The loss of a currency's purchasing power over time.

INFLATION RATE - The annual rate at which a currency loses purchasing power.

INITIAL INVESTMENT – The amount of cash invested at the time a property is purchased.

INTEREST-ONLY MORTGAGE – A mortgage loan in which the borrower makes periodic payments of interest only and pays the full principal balance at the end of the loan term.

INTERNAL RATE OF RETURN (IRR) – The rate of return that discounts all anticipated future net cash flows (including the reversion) back to a present value that equals the initial investment.

LEASE - A contract granting possession of land or a specified part of a building for a specified time in exchange for rent.

LESSOR - An owner who leases property to a tenant; landlord.

LESSEE - A tenant who leases property from a landlord.

LIMITED PARTNER (LP) - An investor in a limited partnership who typically has none of the management responsibility and whose liability is limited to the amount of his or her investment.

LIMITED PARTNERSHIP - A partnership having a General Partner who manages the partnership's investments and bears unlimited liability and Limited Partners who have no management control and whose liability typically is limited to the amount of their investment.

LIMITED PARTNER'S RATIO - The ratio between the amount invested by a particular limited partner to the total amount invested by all of the limited partners.

LONG-TERM CAPITAL GAIN - The gain on an asset held more than 18 months (per the Taxpayer Relief Act of 1997).

MARGINAL TAX BRACKET - The rate at which the investor's next dollar of income will be taxed.

MARKET VALUE - See Fair Market Value.

MODIFIED FINANCIAL MANAGEMENT RATE OF RETURN (MFMRR) - See Modified Internal Rate of Return.

MODIFIED INTERNAL RATE OF RETURN (MIRR) – An alternative to conventional Internal Rate of Return (IRR). IRR will usually fail to yield a result in a situation where there are negative cash flows. The MIRR calculation takes any negative cash flows (after utilization of reserves), zeroes them out and discounts them at a safe rate back to day one of the investment period. The discounted amount is treated as additional capital needed on day one. MIRR also takes positive cash flows and compounds them forward to the sale year, using the reinvestment rate (also known as the risk rate).

MORTGAGE - A lien against a property that secures a mortgage loan or note.

MORTGAGEE - The lender in a mortgage agreement.

MORTGAGOR - The borrower in a mortgage agreement.

NET OPERATING INCOME (NOI) - A property's Gross Operating Income less the sum of all operating expenses. NOI represents a property's profitability before consideration of taxes, financing or recovery of capital.

NET PRESENT VALUE (NPV) - The discounted value of all of a property's future cash flows (including the reversion) less the initial cash investment.

NON-RESIDENTIAL PROPERTY - Real property that does not satisfy the definition of Residential Property; property not primarily intended for use as dwellings.

OPERATING EXPENSE - Expense necessary for the maintenance of a piece of real property and to insure its continued ability to produce income. Loan payments, depreciation and capital expenditures are not considered operating expenses.

OWNER-OCCUPANT - A property owner who occupies part or all of his or her property.

PASS THROUGH - An operating expense that is passed on, in whole or in part, to a tenant. For example, a lease may require that a particular tenant pay a pro-rata share of property taxes in excess of \$10,000. If the tax bill is \$50,000, and the tenant occupies 5 percent of the property's rentable area, then the tenant must pay 5 percent of \$40,000 (the amount of the tax bill over \$10,000), or \$2,000. The landlord treats this as an income item; often call a "recoverable expense."

PASSIVE ACTIVITY - A business or rental activity that the taxpayer does not materially participate in managing or running. See also, Passive Loss Allowance.

PASSIVE LOSS ALLOWANCE - The dollar amount of losses from passive-activity investments that an individual taxpayer may deduct against ordinary income. In general, losses from passive activities can only be used to offset income from other passive activities. An exception exists for owners of rental real estate, who may deduct up to \$25,000 of net losses from rental real estate investments in which they actively participate. This allowance is reduced for taxpayers with Adjusted Gross Income over \$100,000.

PERSONAL PROPERTY - Property that is movable, not permanently attached to the real estate. Appliances are personal property.

POINT(S) - A fee paid to a lender for the lender's service in making the loan. Typically a point is equal to one percent of the amount of the loan. Points are not deductible as an expense, but must be written off over the life of the loan.

PREFERRED RETURN - Each limited partner may be entitled to an annual, non-compounded return on his or her investment before the general partner receives any return.

PRESENT VALUE (PV) - The discounted value of a series of future cash flows. The discount rate is chosen to compensate for the decrease in the value of money over time.

PRINCIPAL - The amount of a loan, exclusive of any interest.

PRO FORMA - A statement or report of projections about the possible future performance of an income property. A pro forma uses assumptions as to future revenues, expenses, interest rates, tax considerations, etc.

RECOVERABLE EXPENSE - See Pass Through.

REFINANCE - The process of retiring all existing loans against a property and replacing them with a new loan. In a cash-out refinance, the new loan is greater than the sum of the loans being retired and the borrower receives the difference in cash.

REHABILITATION TAX CREDIT – A credit that may be taken against one's total tax liability for improvements made to certain properties. Credits of up to 20 percent of the improvements made to historic properties and up to 10 percent of the improvements made to non-historic properties are available. A variety of conditions and limitations apply, including the dollar value of the improvements in relation to the property's basis, the amount of time allowed for the project, certification requirements, passive loss limitations, alternative minimum tax considerations and others.

REINVESTMENT RATE - In Modified Internal Rate of Return, the rate at which you believe you could reinvest the positive cash flows from your investment. Also, Risk Rate.

RENTABLE SQUARE FEET - The portion of a rental property that may be leased to tenants. For example, in a multi-tenant office building the office suites themselves contain rentable space, but hallways and stairways outside those suites typically are not included as part of the rentable area.

RESALE - See Reversion.

RESIDENTIAL PROPERTY - Real estate designed and intended as dwellings, including single- and multi-family homes, but not hotels or motels. A property that combines both residential and non-residential uses must derive at least 80 percent of its gross rental income from dwelling units to be considered residential for purposes of depreciation. If a

mixed-use property is owner-occupied, then the fair-market rental value of the owner's unit must be taken into account when determining the residential or non-residential status of the property.

RETURN ON EQUITY - The ratio between the Cash Flow before Taxes for a given year and the projected selling price less the sum of all mortgage balances for that year.

REVENUE RECONCILIATION ACT - Tax law passed in 1993, which changed the useful life for non-residential property, introduced the concept of "real estate professional," and limited the tax on capital gains to 28 percent; the capital gains provision was superseded by the Taxpayer Relief Act of 1997.

REVERSION - The value of an investment at the time of its resale.

RISK RATE - See Reinvestment Rate.

SAFE RATE - In Modified Internal Rate of Return, the interest rate at which you believe you can put the money aside, in a secure and reasonably liquid form, so that it will grow to meet the amount needed to cover future negative cash flows.

SENSITIVITY ANALYSIS - An analysis where one or more independent variables is altered to determine the effect on a particular dependent variable. For example, one might test how different rental rates affect the cash flow before taxes, or how different purchase prices affect the internal rate of return. Also, What-If Analysis.

SHORT-TERM CAPITAL GAIN - The gain on an asset held 18 months or less (per the Taxpayer Relief Act of 1997).

SOURCES OF FUNDS - A listing of the cash and mortgages necessary to acquire the subject property. The total Sources of Funds always equals the total Uses of Funds.

STRAIGHT-LINE DEPRECIATION - A depreciation method that allows the owner to write off an asset's basis in equal amounts over its useful life. For example, if an asset were to have a 10-year useful life, the straight-line depreciation allowance each year would be 10 percent of the basis. Note that in the tax code as of this writing there exists a so-called half-month convention for real estate, where the taxpayer is allowed only one-half month depreciation in the month of acquisition and one-half month in the month of resale.

TAX REFORM ACT OF 1986 - A tax bill that substantially altered the treatment of capital gains, ending the 50 percent capital gain exclusion. The law also introduced the concept of passive activity investments and limited the losses from such activities that could be taken against ordinary income.

TAX SHELTER - An investment vehicle that can shield a part of an investor's ordinary income from taxation.

TAX-DEFERRED EXCHANGE - A provision of the tax code (sec. 1031) that permits property owners to exchange like-kind properties. If certain criteria are met, the parties can defer recognition of gain or loss and therefore also defer the tax that might have occurred in an outright sale.

TAXPAYER RELIEF ACT OF 1997 - A revision to the tax code that reduced the maximum tax rate on long-term capital gains from 28 percent to any of a variety of rates (25 percent, 20 percent, 18 percent, 10 percent, or 8 percent), depending upon the tax bracket of the taxpayer, the extent of prior depreciation, the acquisition date of the property and the length of time the property is held.

TENANT IMPROVEMENTS (TI) - Improvements made to a rental unit by a landlord for the benefit of a tenant. Such improvements are a capital expenditure, not a repair.

TERM - The number of periodic payments over which a loan will be amortized.

TREASURY BILL - A government obligation representing a virtually risk-free investment.

USEFUL LIFE - The length of time, as specified in the tax code, over which an asset may be depreciated. The useful life for tax purposes is not necessarily the same as the actual physical life expectancy of a particular asset.

VACANCY AND COLLECTION ALLOWANCE - A deduction from the gross scheduled income for losses due to unoccupied space and uncollected rent.

WHAT-IF ANALYSIS - See Sensitivity Analysis.