Sample Exam Questions: After Tax Proforma

Note: Credit will be awarded only if you fully document your solution.

You have the opportunity to invest in a small office building, that can be purchased for $300,000, for which a 75% Ltv bullet loans is available at 6.5% that has 3 points and a 7 year term. If the loan is prepaid in before the 7 year term there is a prepayment penalty of 1% per year early that it is repaid. The land value is estimated at $60,000 and $40,000 of the purchase price is deemed to be 7 year property for depreciation purposes. There are no 15-year depreciable land improvements for this building. The figures below are for a “above line” NOI. $3250 per year in projected capital expenditures were deducted, above the NOI line.

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI</td>
<td>25,000</td>
<td>26,000</td>
<td>27,000</td>
<td>28,500</td>
<td>30,000</td>
</tr>
</tbody>
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You project you can sell this building for $350,000 in five years and will incur 7% selling expenses. You have no Passive Income Gains and make more than $150,000 per year so you will have to suspend any tax losses may incur. Your marginal tax rate on ordinary income is 40%, on depreciation recapture is 30% and on capital gains is 20%.

i) What is your after tax IRR on this investment for a 5 year holding period? {13.0%, using the mid month rule for the first and last year’s depreciation. Also remember to amortize points over the loan loan term and that any unused points can be deducted in the year the load is paid off. A prepayment penalty is considered interest to the bank, so it is tax deductible to you in the year paid.) What is your effective tax rate on this investment? {25.7%}

ii) If you could sell this property after 3 years for $330,000 (with 7% selling expense), what is your ATIRR. {7.7%, Note: Due to the prepayment penalty you will show negative taxable income from operations. You need not suspend this loss as you have a greater tax due on sale for depreciation recapture, so on net you will be a taxpayer in year 3} What does this indicate about the optimal holding period for this building? (Higher return if you hold longer, as shown in Part i).

iii) The bank also offers an 85% LTV bullet loan at 7.5%, with 5 points. If you keep the building for 5 years, what is the marginal cost of the additional funds? {21.6%} Is leverage working for you under this scenario? Why or why not?

iv) Outline the various choices you have in the disposition of your building and note advantages and disadvantages of each choice. (Use Chapter 14 and associated lecture to guide you here)