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Benefits Of A Real Estate Exchange

The real estate exchange takes more patience and hard work to set up a successful exchange than it does to arrange a straight purchase and sale. Some property owners and their agents simply do not understand the benefits of an exchange or are worried about the strict requirements imposed by the Internal Revenue Code.

The main benefit of a *tax-free* exchange is just that–freedom from a tax. The gain that could be realized by one or both of the principals in the transaction does not need to be recognized at the time of the closing. The tax is deferred until the property owner makes a taxable disposition of the new property at some later time.

An owner can make a series of exchanges and can defer tax indefinitely. Upon death, if the property ends up in the estate of this owner and a stepped-up basis is achieved, some tax may be avoided permanently.

The benefit from the tax postponement is apparent. The owner can reinvest the full equity in other property, including gains, without any decrease in value due to tax payments. In effect, the government extends an interest-free loan to the investor, who then is able to obtain leverage over and above that obtained from regular mortgage financing.

In addition to the tax benefits, an exchange (tax-free or not) can be used as a financing tool, since it permits the substitution of real estate equity for cash. There are many other reasons to exchange properties. Following are a few of the most common:

- **Exchange between land and improved property.** Some owners of income producing improved property would like to exchange for raw land with potential for long-term appreciation. Their depreciation deductions may be low and the non-depreciation land is not a problem. If the investor chooses land with a good growth potential, he has put the full amount of his equity into another investment. (The owner of the land transfers equity into a property which gives immediate income, and also may now depreciate part of the original basis in the land.)

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- **Exchange for more easily financed property.** An investor can exchange for property that is capable of supporting a mortgage with a higher loan-to-value ratio. For example, property that qualifies for a mortgage not exceeding 50% of its value might be exchanged for a property on which a lender will make an 80% loan. Therefore, after the exchange, an additional 30% of the equity can be released in cash for other uses. The exchange can be tax-free, as is a refinance of a property already owned.
- **Buyer short of cash.** If a buyer does not have required cash for a purchase, and is unable to get an adequate mortgage, the seller usually will not accept the offer or will extend a large purchase money mortgage. An exchange means he can take other desirable property of the buyer in lieu of taking back a mortgage. The seller may also defer all or part of the gains tax that would have been due on a sale.
- **Acquire more salable property.** When a property has been on the market for some time without a buyer, the owner may be able to exchange for another that can be sold for cash more readily. Care must be taken in this type of cashout exchange, because if there is intent to resell the acquired property immediately, the tax-free exchange rules do not apply. (The new property must be acquired as a property *to be held* for business or investment in order to qualify.) But since the original property was held for sale (and presumably the gains tax was going to be paid on sale) the seller's accountant may find that the tax to be paid is the same after either transaction. The other owner in the transaction may make a fully tax-free exchange.
- **Acquire larger income property.** A professional man or woman owns a 10-unit apartment building that is too small for an on-site manager. The income is desirable and a sale would be costly because of a large gain. The equity should be exchanged up into a larger apartment property that would adapt to professional management. It could have increased income to cover larger loans and management fees. The step-up in the owners basis could give a larger depreciation. After the transaction the owner can have the same or higher income and be relieved of management problems. ❏

Commercial Development On Unusual Properties

In many metropolitan areas, commercial land for development is in very short supply. Developers are converting older warehousing to shopping areas, demolishing existing buildings to build new projects in areas in transition. However there may be many hundreds or even thousands of parcels of property that have been overlooked. Many are ready for commercial development close to downtown areas, suburban commercial developments, and densely populated areas. Owners of many of these properties consider the property as "surplus" and have not considered development.

Some of these properties are in the inventories of city, county and state ownership and are surplus parcels that were unused in street, highway and freeway development. Others are owned by railroads.

All of these infill properties have one thing in common–they all are unusual pieces of real estate. They are peculiar shapes and sizes. One railroad parcel that we heard of was 50 feet wide and 26 miles long. This parcel lay unused for many years until a developer utilized parts of it for several self storage projects. The developer formed a joint venture with the railroad, with the railroad contributing the land and the developer his self-storage development expertise.

Throughout the country now there are shopping centers built under freeways, commercial buildings erected in the unused areas under bridge approaches. In some states, the air space above busy highways is leased and used for restaurants or other businesses that can be used by travelers.

One real estate broker contacted a railroad about surplus property in his area and was handed a stack of descriptions of over forty properties that were available. No one at the railroad was doing anything about marketing these properties.

When you see an unused parcel of land in your area, let us research it for you. We may be able set up a purchase, lease or joint venture that can change that eyesore lot into a major development. ❏

Negotiating The Sublease

With changes in business strategies, some existing tenants wanted to sublease all or some of their rented office space to eliminate some locations and shrink operations in others. In this situation, the problem for landlords is whether it is a better strategy to enforce lease restrictions against subleasing or to work with tenants on the theory that the sooner cheap sublease space is filled, the better for all. (In addition, another problem could be whether landlords should insist on sublease restrictions in new leases being negotiated now.)

Lease Restrictions

If there is no provision against the sublease in the original lease, the tenant has the right to assign or sublease without the owner's consent or approval. However, most leases do contain this provision. In the mid-1990s, when rents were at high levels, tenants could obtain the landlord's consent only if no other space was available in the building, and even then, the landlord might have insisted on sharing in any profit realized on the sublease. (In those days, sub-rent was often higher than the prime rent.)

At this time, few tenants are trying to sublease for a profit. Instead, they are interested in cutting costs of unused space and are often willing to accept current market rents, something landlords are reluctant to do for prime space.

Landlord and Tenant Cooperation

Although the building owner may take the position that no consent will be given to a sublease as long as prime space is available in the building, the tenant may make some good arguments for cooperation.

First, when there is much space available all around, a tenant looking for space can find it easily. A landlord is better off having a tenant in possession, even with a sublease, because the tenant may stay when the sublease expires.

Second, the landlord takes the risk that a prime tenant with much excess space may default under the lease either by being forced out of business or because the tenant is willing to risk a lawsuit to collect unpaid rent. By being cooperative in finding a subtenant, the landlord reduces the risk of a default by the prime tenant and has the additional security of the subtenant's rent payments (even though the amount may be less than the prime rent).

Perhaps most important, the landlord may gain the reputation for good tenant relationships that can help in the competitive years ahead. Helping the tenant to shed excess space can pay off when the tenant considers renewal of the present lease. Landlords who are known for taking a reasonable approach to tenant problems, both during and after lease negotiations, are bound to have an edge when a tenant must make a choice between very similar rental space in different buildings. ❑

Extra Income From Campus Apartments

When an owner has an apartment property near the campus of a University, there are particular problems. The competitive situation dictates that leases be offered for one semester of nine and a half months. A twelve-month lease for students is virtually unheard of. That means there are lots of vacancies as soon as final exams have ended. (This does not apply to a few University communities where there is always an apartment shortage. In those few places, the student must lease for 12 months or have no lodging.)

There are ways that might help turn the months of vacancies into extra rental income.

First, during graduation week, the vacant apartments are rented to parents by the management company on 3-day or 5-day leases. The parents like being closer to the activities that attracted them to the campus than they would be in outlying motels.

Second, summer students taking courses at the university welcome the chance to rent an apartment on a week-to-week basis. This is particularly true of students and employees from other colleges who don't have the time to search out living arrangements for, say, a six-week summer course. ❑

Screening Prospective Tenants

The property manager provides the tenant applicant with the lease application which must be filled out for the interview. A leasing agent may assist during the review process, but the final selection of tenants is ultimately the property manager and owner's responsibility.

All leasing personnel should be informed that the company does not discriminate on the basis of an applicant's race, sex, color, creed, or national origin.

The screening process helps determine the prospect's desirability and verifies financial and nonfinancial qualifications. When all information has been received, the applicant's file should be given to the property manager and/or owner for final review. Decisions made during this process are based on the following criteria:

- Impressions created by the prospect when interviewed.
- The prospect's employment history if the prospect is applying for residential space; company or business history if the prospect is applying for commercial space;
- Information gathered from verifying the prospect's references and from the completion of a credit check;
- Compatibility of the tenant to the property type.

When the application is approved, the property manager should prepare the lease and other appropriate documents that require the applicant's signature. Commercial tenants will probably have an attorney review the lease, which may require a certain amount of negotiation. Upon approval, the lease is signed, and security deposits and rent payments are collected as specified in the lease.

When an applicant is disapproved, he/she should be promptly notified. If the disqualification resulted from a credit check, the law requires that the applicant be informed of this. To protect against possible litigation, rejected applications should be kept on file with complete statements about why applications were rejected. ❏

Help With Investment Real Estate

When you have searched for new real estate investment opportunities, with values that have been changing, you know that finding and evaluating them is becoming more sophisticated and complex. More investors are turning to real estate consultants as a means of providing a sounding board for their ideas as well as expertise in the planning and construction stages for their projects.

Today's investor in real estate must have a grasp of market conditions and potential that is usually beyond their own available time to attain. Investors need assurance about the true condition of the market. With increased competition, the market place is becoming more complicated.

Feasibility studies are essential for commercial office, industrial, resort and hotel investors. With this kind of information, planning is better and there is less chance for error.

Real estate investing is not just looking for the structure and the land. It is investing in the type of property that you want at the price and terms that suit you at the time you want to make the purchase.

Our office is open and ready to assist you. We have been experts in property values in this area for a long time. We can help you with enough information so that you can make your own decisions on the value of property either in listing your present property for sale or in purchase of another. If you wish to consider structuring a tax deferred exchange into that next property, we can guide and aid you with that transaction.

Let us guide you in your investments. ❏