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Improving Your Investment Portfolio

When you make your investment in real estate, it is implied that you want to make money. The cash can come from direct income from the property or from capital gains from a sale after an increase in value. Either way, the investment must be managed, considered, and watched at all times. If the owner and manager are taking care of business, there may be ways to increase the income, and the value. There is always the possibility to make a sale for the right price and terms. Keeping aware of the market might bring an opportunity to make a tax-deferred exchange into a property with more benefits for the owner.

Real estate investors often own various kinds of properties. They may have a mix of commercial, residential income, land and groups of houses. These owners have an extensive *portfolio* of investment real estate.

Owners of portfolios of stocks and bonds meet with or call their broker often. Like seeing a doctor or dentist at regular intervals, it makes sense for real estate investors also to meet with their real

estate investment representative or counselor at least a couple of times a year, perhaps quarterly. Exchanging ideas with the professional who has the daily pulse of the real estate market can be profitable. At each meeting, the investor can plan on finding out the current market conditions that will have an effect on equities that are now owned or that could be acquired.

In many cases, the owner's investment representative is also the property manager. If not, perhaps the property manager should also be present at these meetings at least once a year.

The Program

Planning any professional meeting in advance will make it more productive. To keep any business meeting on track and save everyone time, notes should be made in advance by the property portfolio owner or the real estate investment specialist. The following are some examples of questions or subjects that might



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This publication is not a solicitation but is an information service from this office.

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When ideas in tax and other legal areas in this publication seem to fit your situation, it is recommended that you discuss them with your professional advisor before taking action.

(continued)

be discussed at each meeting; or some at least once a year:

- 1. In what ways can the management of my properties be improved? Can any current expenses be decreased?**
- 2. How do our rent levels compare with the others in the immediate area?**
- 3. Have there been collection problems—are all rents current at this time?**
- 4. Is the current maintenance of the properties up to the best standards?**
- 5. Has the planning department approved any zoning variances in the areas of my properties? Would it enhance the value of any property of mine to apply for a change in zoning?**
- 6. Have any new construction projects been started nearby? What are they and what effect might they have on my properties or rents in the area?**
- 7. Is the present use of my properties the highest and best use?**
- 8. What improvements could be made that would increase the income?**
- 9. Are we attracting the kind of tenants that should be in this type of property? Would anyone else be more desirable?**
- 10. Are any properties of the type we own on the market at this time in this immediate area? What is the price and how is that price justified? Has there been any buyer interest in it at that price? Should we consider adding it to my portfolio of properties? If so, how can we acquire it, either by cash purchase or exchange?**
- 11. Is my leverage position in all properties at its maximum potential? Would there be any benefit in a refinance of any of my properties at this time?**
- 12. Are any properties in this portfolio suitable for a condo or co-op conversion? If so, should we do the conversion or sell**

the property to an expert in that field?

13. Can we offer any property for syndication? How would we handle it?

14. Which of my properties has the best set of benefits for me? Which has the least benefits?

15. Which of the properties in the portfolio would be the most desirable to dispose of at this time?

Setting Those Goals

When each of the points in the meeting have been covered, both the property owner and his/her representatives should have a much better picture of the property portfolio and what should be accomplished. At this time, maybe each property owned should be graded in order of the most desirable to the least desirable to continue holding. Then the answer to item #15 will be apparent.

This can now give the final result of the meeting. This can be the “bottom line” and the reason for the meeting. The goal should be set for the sale or exchange of the least productive property (to this owner) in the list of real estate owned. This might be the property of the highest potential to someone else, but of less interest to this owner because of the increase in value already shown by current estimates of worth or appraisal. This result is very satisfying since the “weak” property is identified and the goal is set to use its equity to acquire a certain type of real estate that will fit better into this owner’s portfolio.

This gives a result for the owner that is seldom achieved by most investment real estate owners. At all times, there is a definite effort being made by a top real estate professional to improve the owner’s position.

The problem of a taxable gain from that property need not be a consideration to this owner. The broker, working with the property owner’s attorney and accountant can arrange to defer that tax by setting up a tax-deferred exchange into a more productive property. □

Benefits of Using A Real Estate Tax Free Exchange

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 exchange transaction does not need to be recognized at the time of the closing. The gains 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.

It takes more patience and hard work to set up an exchange than it does to arrange a straight purchase and sale of real estate. 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.

Owners must get used to using this transaction as just another tool like a purchase, sale, option or lease.

The real estate exchange has become a normal business tool used by investors, corporations and business owners throughout the country. If you have not used this tool, you may have already paid too much in taxes.

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 for cash. There are many reasons to exchange properties. Following are a few of the most common:

- **Acquire improved income-producing property using land for the currency.** 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.)

- **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.

- **Lack of cash is the problem.** 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.

- **Trade for a property to sell for cash (and pay the tax).** 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 cash out 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 capital 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.

- **Trade up to a 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. □

Office Building Vacancy Comparisons

In a slowed economy, newer buildings may fill up at the expense of older buildings. Since new buildings cost more to build than the older ones, rents may be higher. The actual dollars-per-square-foot costs must be compared, along with other benefits that the tenant may receive, before a final decision is made by the tenant on staying or moving.

In many areas, there are still a number of vacancies reported in office buildings. Most of this available space is in the newer properties. One of the most important jobs of a leasing agent for a building with this available space is to analyze other buildings to see if any tenant could be induced to move.

Here are some of the items for comparison:

1. What is the time factor for employees at the old location? In a business' expansion at the old location, they may have expanded to different floors or to different buildings, as more space was needed. There may be a big loss in employee time due to the inconvenient layout.
2. Maybe the tenant is planning an expansion in

the next few years, which will make it necessary to rent space in the old location at then-current rentals, raising the average rental per square foot for the tenant's entire space, in a less than adequate location.

3. Don't assume that the new space rentals are not competitive. Cost-of-living clauses in the tenant's existing lease may have escalated the rent level up to the costs in the newer, more modern building.
4. The newer building represents more efficient design, better and newer lighting, modern in every way. The intangible improvements in employee morale and efficiency might overcome any slight difference in dollar-costs per month.
5. Finally, a change in location to a more, prestigious building in a better part of the community can contribute to the reputation of the tenant—and ultimately to the profitability of the business.

The tenants who could be good new tenants at the new location will usually not be aware of all of the benefits of a move until they are contacted and are given the opportunity to make the comparison. □

Your Real Estate Investment

Knowing what you can do in some investment situations can be the difference between an annual profit or loss in your currently owned commercial property or the one you intend to acquire. How you acquire it can be important.

The professional commercial real estate broker is in the position to represent a client in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. This real estate practitioner stays aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result

in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and/or tax advisor. We always recommend consulting with these professionals during the planning and closing of major real estate transactions. All can affect taxes and estate planning.

We are the heart of your professional team, creating the real estate transactions that will be needed to expand your estate. Let's get together to evaluate your present portfolio of properties, or review your plans for future acquisition.

Starting with your present position and your goals for the future, we can set out moving directly toward achieving those goals. □



A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.