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A Full Service Commercial Real Estate Company

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Commercial Real Estate Investment Newsletter

Condominiums Built For Business Owners

Like apartment dwellers who are finding that it is less expensive to buy than to rent, business and professional firms are moving toward buying offices rather than leasing. While buying or constructing an entire building is an option for major corporations or for smaller firms outside metropolitan areas, owning commercial space generally means being part of a condominium structure.

Condo Office Buildings

Small office buildings are the most common type of commercial condominiums. The strongest demand for this type of space is from lawyers, doctors, advertising firms and other professional and service companies, as well as small private corporations. These firms often accumulate capital not needed in their business, and their occupancy of a particular location can have value to them in the form of goodwill so that they are interested in controlling the space.

From a financial point of view, the basic appeal of commercial condos space is that over the long run, owning can be considerably less expensive than leasing. While rents may be low in the current market, renewals over the years are likely to mean rent increases. By comparison, mortgage financing is now available at relatively low fixed interest rates for terms of ten years or more. In addition, well-

located and well-maintained space can appreciate significantly over the period of ownership.

Tax considerations are less favorable for owners as compared to tenants. A tenant can deduct 100 percent of rent payments as a business expense. A condominium owner can deduct only the interest on a mortgage loan, as well as depreciation (using a 39-year life). While the tax benefit of leasing may be slightly better than those from owning, the likelihood of appreciation of value should more than offset the difference.

A further advantage of condo ownership is that it eliminates undesirable provisions that may be in a lease. For example, a landlord may have the right to relocate the tenant if a major tenant requires more space. Using an office at night or on weekends may require the tenant to pay for utilities and services. In general, small tenants have little negotiating power when negotiating a commercial lease.



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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)

Management Concerns

Like a residential property, a commercial condominium is managed by a board of directors made up of unit owners. Certain matters may require approval of a majority of owners, thus assuring each owner a say in any decisions affecting the building. Often the condominium charter gives the board a right of first refusal when a unit is offered for sale. In this way, control over the type of building occupants can be maintained. This arrangement frequently prevails when all occupants of the building are in the same or a related business or profession.

Changing Needs In Space

A frequent concern of small business or professional owners is that space requirements may change at some time in the future. In a rental building, where turnover is likely to exceed that in a condominium, a tenant is more likely to be able to adjust its space requirements. In the case of a condominium, an owner anticipating a

future need for more space can buy a larger space initially and lease it short-term until required (assuming leasing is permitted). However, it may be more difficult to obtain additional space if needed.

Cooperative Office Buildings

Cooperative office buildings became feasible only after a 1986 tax law permitted business corporations to qualify as "tenant-stockholders" eligible to deduct taxes and interest payments. However, there appear to be relatively few office co-ops.

One major difference between a cooperative and a condominium is that a co-op board of directors has the right to disapprove a proposed buyer, whereas a condo board only has a right of first refusal. Thus, cooperative ownership gives greater assurance that tenants will occupy a building in a similar business or in related lines of business, if that is the intention of the owners. □

Investment Decisions Between Garden And High Rise Apartments

There are distinctions between garden and high-rise apartment buildings when viewed as investments.

Building-Land Ratio For Depreciation

Purposes. While garden apartments have much more open space, the land is usually substantially less expensive than that in high-rise apartment projects. The result is a more favorable building-to-land-cost ratio for depreciation deductions (i.e., the land represents a smaller percentage of the total cost than in the case of a high-rise project). Since only the portion of total costs attributable to the building is depreciable (land, of course, is not depreciable for tax purposes), a garden apartment investor frequently can depreciate a larger percentage of his total costs than an investor in a high-rise project.

Elasticity Of Rent Structure. The rents charged for garden apartments tend to be quite elastic. Rent reductions are very likely to generate

increased demand, while rent increases often cause tenants to search for alternative housing. On the other hand, rents charged in a high-rise building tend to be higher than in a garden apartment project and are less volatile. This reflects that fact that a high-rise development is more expensive to construct than a garden development, and the tenants tend to be more affluent than garden apartment tenants.

Consequently, high-rise tenants are less likely to be troubled by a rent increase or to be attracted by a rent concession or decrease. For this reason, rent reductions or concessions are not considered by many owners to be a good way to fill vacancies, while they are frequently quite successful in garden apartment projects. However, during periods when vacancy rates have been unusually high, inducements in the form of several months free rent or even a free trip to the Caribbean have often brought excellent results. □

The Buyers For Commercial Properties

If you are new to investing in income property, you may have made a choice in advance of the type of investment property that you wish to own. There are many good types of investment properties: apartments, office buildings, shopping centers, high rise parking garages in downtown areas, warehouses, resort rentals and many others.

Each of these takes a different type of management. Any and all should be under professional management during your ownership. Good management will ensure a profit for you when the investment is sold.

Even before buying the commercial property, you should consider who might be willing to buy it when you want to sell. The specific buyer doesn't need to be identified, but the type of purchaser should be. Will it be an individual, a syndication, an institution, or a pension fund?

Think about it! If you cannot think of potential buyers now, why is the property being purchased?

By identifying the type of potential future buyer, an investor in a property can better concentrate on what features such a buyer will most likely want. Then the investor is able to operate the property with the management company in such a way as to enhance the attractive features, thereby maximizing the property's value to the most likely type of buyer. Here are a few examples of resale factors for particular properties.

- **Apartment buildings** are usually purchased by pension funds and insurance companies only when they are Grade A properties. Syndicators look for Grade B or higher properties. Wealthy individuals are the most

likely prospects for apartment buildings that need to be upgraded and modernized.

- **Office buildings** are typically purchased by users (a bank, an insurance company, or a corporation that intends to occupy all or a major part of the building for its own operations). Foreign investors increasingly seek fully tenanted, income-producing office buildings for long-term investment.

- **Resort properties** (time-share units, beach front condominiums, and campgrounds) generally have a weak resale market. Sale by auction is a distinct possibility and that often results in bottom-dollar prices.

Other Resale Considerations

In addition to identifying potential purchasers, an investor must determine carefully the appropriate time to sell, the economic outlook, potential tax considerations of a sale of investment property, and other uses for the money that a sale would bring. And an investor-owner should make every effort prior to offering the property for sale to ensure that the financial and physical condition of the property justify the maximum possible price. In a shopping center, for example, the rental income stream, cash flow, and occupancy level should each be at the highest possible level. When they are, a greater number of potential buyers will emerge.

Like-kind exchanges are often a tax-wise alternative to resale of investment property. Savvy investors keep alert to exchange possibilities as part of their focus on resalability of a property. □

Exchanges Of Mortgaged Property

In the straight equity for equity exchange of properties that are of like kind and held for investment or business use, there is no income tax liability at all. But there can be a tax liability when the exchange involves mortgaged property unless the right, tax-saving technique is used.

Example: You own an investment property worth \$500,000, which is subject to a \$100,000 mortgage. Your cost basis in the property is \$420,000.

You exchange the property for another worth \$750,000, which is subject to a \$400,000 mortgage. Because you are trading your \$400,000 equity for an equity of \$350,000, you will receive \$50,000 in cash to even off the equities. The other owner has agreed to pay that amount.

Tax Result: You must pay federal tax on the cash you receive. (Cash boot.)

Solution: Instead of taking the \$50,000 cash to even the equity, have the other owner of the property being acquired use the money to reduce his mortgage by \$50,000 before the closing of the transaction. That evens off the equities, so you receive no cash and owe no tax.

Here is another thought. It is always a tax-free event when you refinance a property that you already own. Either owner can receive tax-free cash by refinancing an owned property either before or after this transaction, but not as part of the exchange.

For instance, you can refinance the second property after closing the exchange transaction if you need cash. □

Space Sharing Executive Suites

With the new revolution in communications, building owners must keep up with the changing needs of the corporate tenant. Often the larger, well-organized businesses do not need the space that was necessary just a few years ago. Electronic communications to and from employees have substituted for leased office space. Managers are more willing to grant favorable lease terms to operators of shared space. The operator sometimes receives a monthly management fee for operating the shared space plus a portion of rent revenues over a certain amount.

Solving Tenant's Needs

Tenants in an office suite are offered a private office within the suite that has a receptionist, secretarial help, conference rooms and other amenities. This can be a big saving for small space users or users who need a small office for only a short period of time.

Another user is from the large corporation that needs small branch offices in different parts of the country. Other users might be individuals who need a private space for investment or other work activities as well as professionals such as attorneys or accountants who work primarily away from their offices.

Existing Leases

Companies that have excess space that cannot be leased in its entirety can use the concept of shared space. The company's existing facilities such as copier rooms, computer rooms, cafeterias already are available. Any income from this type of shared space can be nearly 100% profit.

If this is space that is leased by the company rather than owned space, the lease must be reviewed carefully to see if a sublease could violate the sublease/assignment clause of the lease. □

Suburban Office Buildings

With available investment capital becoming available, demand for commercial real estate continues. Suburban office buildings remain many investors primary acquisition target.

These investors reason that a suburban office building that can be purchased at a price below replacement cost must be a good buy. Careful choices must be made, as there must be a demand for office space in the area and a gradual increase in rents. Since rents have increased in most submarkets, the long-term demand for office space looks good.

Suburban vs. Downtown

Recovery in suburban office markets has outpaced

downtown markets because the suburban markets began from a more disadvantaged position. Overbuilding during the 1980s was much greater in the suburbs due to the lower cost of land and the economic feasibility of constructing smaller buildings. Consequently, the national suburban office vacancy rate at the end of the decade was approximately five percentage points higher than the national downtown rate.

Construction and Absorption

Recent years have brought many positive changes in the U.S. office market. The biggest reason was the almost complete absence of new construction for several years. Just 5 million feet of new space was delivered annually during this period, while absorption averaged 42 million feet annually. □

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 while. 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. □

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate.