

# Cravey

Real Estate Services, Inc.



A Full Service Commercial Real Estate Company

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**Cravey Real Estate Services, Inc.**

5541 Bear Lane, Suite 240

Corpus Christi, TX 78405

361-289-5168 Office

361-289-5442 Fax

[cravey@craveyrealestate.com](mailto:cravey@craveyrealestate.com)

[www.craveyrealestate.com](http://www.craveyrealestate.com)

## Commercial Real Estate Investment Newsletter

### Commercial Real Estate And Business Owners

Whatever the kind of property used, the user has the option of purchasing or leasing. Should you buy the house you live in, or lease it from someone else? With few exceptions, there would be an overwhelming response to "own it." The benefits weigh heavily toward ownership. With business property, the answer sometimes may be a lease instead.

Real estate investors who enter into a long-term lease instead of buying property make a decision with implications that can have an effect on both financial and tax positions. The important difference of the long-term lease from a straight purchase (outright or with a loan) is borrowing (renting) the property itself for financial benefit. Payments for the use of real estate can be beneficial, with lease payments fully deductible expenses.

Sometimes the choice of owning is not available and the property can only be leased not purchased. During a period of time when money is not available except at very high rates, leases may be the only consideration. Another time when only leases are practical could be with the best possible location in a large city, where institutional owners hold the land on a long-term basis.

#### Here are examples of some property users who must make this decision:

1. Some real estate users have a prime objective of maximum cash flow now, in commercial or residential income properties. They will be interested in securing capital, investing for maximum return.

2. Any store chain, fast food outlet, other franchise operations must use real estate in the operation. Should their money be used to purchase property for their locations or be retained for working capital and expansion?

3. An owner wanting the highest leveraged position, with the greatest interest in securing the largest gain possible from the property. This owner could avoid tax liability on current income from the property.

#### Property used in Trade or Business

With a new business, the owner of that enterprise has the choice of buying or leasing the business location. In the beginning, this choice has little meaning to most. The owner most often will lease a business location, preserving capital for

**March 2015**

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)

operation of the business. Capital is always critical in early operations and is seldom in enough supply to purchase real estate.

### **A Later Choice**

The choice of buying or leasing remains as an alternative even later. After some years and much success, the owner may wish to expand, change locations, or just have a business location that is “tailored” to the specific needs of his operation.

So, the business owner buys a property with a small down payment. He borrows and builds a building, which is perfect for present and future needs of the business. In addition to the best location, there are other benefits that might help to make the decision to purchase the property. These are:

1. Like a home, the owner has the security of owning the property, and the peace of mind of knowing that no one will evict the business at some later time.
2. The new improvement (building) on the property is a depreciable asset and so provides the added benefit of tax shelter for current income from the business.
3. The interest paid on the loan is a business deduction. The difference, the amount paid to principal, builds equity in the property.
4. The ownership of the real estate gives the owner a stability and added stature in the community, increasing his financial strength.

Now, in addition to security and self-image, the owner has all of the elements of a good “leveraged” investment: Low down, large loan and depreciation of the improvements. The cost may have been fairly small. After a minimum down payment, the payments on the loan may not have been too different from the previous monthly lease payments.

### **The Next Buyer**

Still later, the picture changes again. After using the property for ten or fifteen years, this owner might be approached by a broker with a buyer for a good property to own as a passive investment. The investor prefers a commercial building with a good tenant and a long-term lease. The broker suggested a purchase of an existing business property from the present owner who might then lease back the property.

The big change for the business owner happened over the years. Because of inflation in those years of ownership and the annual reduction of the mortgage with the loan payments, he has built an enormous equity in the property. The original down payment

has now grown to a huge equity – maybe hundreds of thousands or millions of dollars!

### **The New Benefits**

The purchase of the property was an excellent move for the business owner, when it was done. Now, with the passage of time, his position has changed. When discussing this with his Real Estate Investment Counselor and CPA, the following list of benefits for the sale of the property, then a leaseback, were developed.

1. The hundreds of thousands of dollars (or millions) of capital tied up in the real estate ownership would be released for expansion of the business, operating capital, investments, personal use or retirement.
  2. The business owner’s balance sheet could improve. The amount of the current real estate loans would not show as a liability and the cash would increase the asset side.
  3. The seller still has the use of the original building, built to the specific needs of his business, but now it will be with a long-term lease.
  4. The rent paid on the building after the transaction is deductible as a business expense, just as it was when the business first started.
  5. If the proceeds of the sale are invested, the annual return may equal the rental payments on the lease, in effect making the rent on the property free of out of pocket expense.
  6. The cash will be received by the seller without any loan approvals and does not have to be paid back.
  7. After the sale, if the business owner reserves the right to sublet the real estate, he may be very flexible on future plans to sell the business or continue to operate it.
- These benefits were all to the liking of the business owner. The only drawback was the tax to be paid on the gain in value. After his CPA computed the actual amount, the tax was minimal compared to the benefits, so the sale, then leaseback was completed.

### **Deductions**

The sale-leaseback often accomplishes more for the seller than getting money by borrowing on the property. The seller is entitled to deduct the entire rental payment as a business expense. On a loan, only the interest can be deducted.

So, the sale-leaseback, in effect, makes the cost of the land depreciable. With a mortgage, the mortgagor can neither depreciate the land nor can the portion of the loan payment that amortizes the land (loan reduction) be deducted. Since the payments on rent are similar to principal and interest payments on a loan, this means that all of the monthly payment (rent) is put on a tax-deductible basis. This may more than compensate for the loss of the depreciation deduction, which was only on the improvements. □

## Getting Loans On Vacant Land

The conventional lenders, banks, savings and loans and similar institutions may slow their funding of the more speculative projects. However private lenders do make loans on land. They will usually loan on land that is intended for early development and will limit the term from a minimum of one year to a maximum of three years.

Many lenders are concerned about the flow of capital into real estate development, noting that more money is chasing fewer good deals. With the turndown in home sales, overbuilding may have brought about a downturn reaffirming the cyclical nature of real estate. With the real estate recovery underway, opportunities may be returning to a previous normal.

Here are some of the considerations for this type of loan:

- **Loan to Value Ratio.** First mortgage land loans may be made for up to 50 percent of the value of the property as determined by an independent appraisal. If the borrower can put up additional collateral, the loan-to-value ratio might be increased by an additional corresponding amount. Where an existing first mortgage already exists, some lenders will consider taking a junior position, but the total of both loans will not usually exceed 50% of total value.
- **Interest Rate.** The interest rate on this type of loan will be high. Sometimes state usury laws appli-

cable to individual borrowers can be violated. The borrower must be incorporated in this case. See attorney for assistance.

- **Amortization.** Typically, vacant land will produce no cash flow, so amortization is not required.
- **Release Price.** The owner of the land is commonly given the right to obtain the release of a portion of the premises from the mortgage lien (so it can be developed and sold) on payment of a larger-than-pro-rata portion of the loan, e.g. 125 percent or more of the ratio of the value of the released premises to that of the whole parcel. This is a form of amortization and increases the security on the remaining portion of the land.
- **Personal Guaranty.** This can be required, depending on the transaction.
- **Developer's Strength.** The experience, reputation, background and financial stability of the developer is very important. A developer with a history of success in this type of project will go far in justifying the requested loan.
- **Demand.** Existing demand for the planned development must be proved. This may require a market analysis by outside experts.
- **Type of Improvement.** A "location-oriented business" such as a bowling alley, motel or restaurant may not qualify the land for a loan, whereas an apartment or office building may do so because of the stability of the rental income once the building is completed. □

## The Right Investment At The Right Time

Sometimes, even the best thought out plans do not work out. Investments in real estate can turn out badly. Investors may then blame the loss on the "real estate cycle" when there were mistakes that could have been avoided by better planning and analysis.

Based on data obtained through interviews with more than 200 real estate practitioners, several costly mistakes were identified and discussed.

**Here are three of them:**

**Misjudging demand.** Developers have faced costly setbacks by assuming that customers existed without undertaking adequate market analysis. For example, a retail development designed to attract shoppers from executive ranks in the adjoining commercial center failed to realize that high-income executives have demanding work schedules and tend to shop during their leisure hours near their suburban homes. Clerical workers, who might shop during

lunch or break periods, cannot afford up-scale store prices.

**Faulty property analysis.** Investors invite catastrophe by failing to thoroughly examine all physical aspects of property improvements, including size, structural stability, and mechanical systems. Some investors have suffered losses by relying on ballpark estimates of rehabilitation costs or by purchasing multi-unit buildings after seeing only representative sample units carefully selected by sellers.

**The investment fallacy.** Too many people have equated real estate investment with a more passive "buy low, sell high" investment in assets such as stocks, gold, and stamps. They have failed to recognize that time, talent, and work must go into maintaining and enhancing a property's value. They have failed to understand that income properties and "investment" properties are largely the fruits of imaginative and capable management. □

## Acquiring The Land For A Project

Soon buying and selling commercial real estate will get back to near normal. Acquiring land for development is necessary no matter what kind of market we are in. Professional real estate assemblers are always looking at and acquiring under-utilized sites within cities or in suburbs. Here are some ideas on how those professionals do it.

- **A Thorough Knowledge.** Only purchase or option property in well known localities to reduce the risk of unexpected surprises. If the locality is not familiar, seek out local professionals for their opinions.
- **Be A Follower.** Being the first to buy increases the risk of being wrong and may mean an unexpectedly long wait until values rise. It is often better to go in after values have begun to increase or after some development has started.
- **Government Maps.** Local governments often have maps and plans for projected roads and highways. These can point the way to desirable acquisitions.

- **Prepare An Acreage Map.** The map should show the ownership of all tracts in the locality and (if known) the asking price of each. This step marks the prime difference between the professional and the non-professional land acquirer.

- **Seek Out Builders.** Try to find a builder willing to let you act as an intermediary in acquiring land.

- **Option Or Installment Contract.** When acquiring property, get a firm commitment from the landowner without the buyer having to pay out cash. This can be done either with an installment contract under which the buyer can pay interest only for the period of years with a right to walk away without further penalty.

**Note:** An investor or investment group retained by a builder to find land is obligated to give the builder the first opportunity to buy in all cases. However, any land the builder does not want may be a good investment for the assembler since its value is likely to increase as new construction occurs. □

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## Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate. A professional real estate practitioner must stay 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 CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

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. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. □

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