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## Investing in Real Estate

by Howard W. Wolosky

It is a gift that keeps on giving." That is how **Donald Hoffman, partner with Hertzbach & Company in Owings Mills, Md.**, often refers to real estate when advising closely held business owner clients.

He explains that if they took out a loan and purchased the property, the service would be the same as on a long-term lease, adding that when they sell the business, they can lease the property to the buyer or someone else, and then, in retirement, they have a stream of income.

### The Context for Clients

In an individual's situation, quite often the investment in real estate is primarily in the form of a principal residence and a vacation home, observes Annette Murray, partner with Wilkin & Guttenplan, in East Brunswick, N.J. It is the experience of Wayne Olson, tax partner with Margolin, Winer & Evens in Garden City, N.Y., that individuals also generally invest in real estate through real estate investment trusts (REITs) or hedge funds. In the alternative, he finds investors may invest in units in limited partnerships or limited liability companies (LLCs) through private placements.

Vic Alexander, chief manager with KraftCPAs in Nashville, Tenn., has similar experiences. "Most of my clients have some form of real estate in their portfolio. For the individual investor, they may buy commercial or residential rental property, participate in a syndication that acquires commercial or residential rental property, or invest in a REIT if they want more liquidity," he indicates. Murray has clients that own a house or small apartment building that generates rental income.

As to most of Alexander's closely held business clients, they usually own the real estate that houses their business. He explains, "It gives them greater control of the location, and allows them to create an additional revenue stream that may continue even after the business is sold. Most of my clients recognize that real estate ownership offers a hedge against inflation and an opportunity to lock in low interest rates for a long period of time in certain economic environments. They also like that real estate is a tangible investment, as opposed to paper investments like stocks and bonds."

Olson indicates that business owners typically invest in their own facilities, usually through single-purpose limited partnerships or LLCs that own the property and enter into net leases with the affiliated operating company. Murray also says it is fairly common for doctors to own the building in which they practice and then rent out space in the building to others.

Real estate investment consulting has worked out very well for Anderson ZurMuehlen & Co., in Helena, Mont. According to Ray Petersen, a partner, the firm created a sister company four years ago, and a real estate agent and a CPA provide real estate consulting services to the firm's clients. "We are focused primarily in the tax deferred exchange area, but we do a lot of our consulting relative to the buy/sell decision," he says.

Much of the real estate of Anderson ZurMuehlen & Co.'s clients is agricultural,

and often the value of land has shot up but the cash flow return remained low.

Petersen indicates that often the firm must advise on disposing all or a portion of the property, especially if the owner is having a hard time servicing the debt on the property. That is where the like-kind exchanges often

It has unique advantages for both individual investors and closely held business owners, but a special due diligence must be applied to real estate investing.

come into play, and the hope is that the property received in exchange can support itself.

### The Recommendations

According to Olson, when a client entertains a particular real estate investment, Margolin, Winer & Evens typically reviews the offering and performs a due diligence to assist the client in making an informed decision.

Particular emphasis is on finances and the tax aspects of the investment.

Once the decision is made to purchase the property, Margolin, Winer & Evens works at developing a tax favorable structure. Olson explains that in connection with the acquisition or a significant improvement of property, the firm will perform a cost segregation study to maximize the current depreciation deductions and related tax benefits. Part of the advice that is given by Murray involves a recommendation on which type of entity should hold the real estate, and, when an individual investor is involved, her firm pays special attention to the passive loss rules.

Alexander advises individuals to try to obtain diversity in geography and type of property where possible, and stick with what

## Easy Access to Return Data

Ray Petersen, partner with Anderson ZurMuehlen & Co., in Helena, Mont. identifies two associations that provide data he finds helpful. The National Council of Real Estate Investment Fiduciaries (ncreif.com) measures real estate return overall for institutional investors and the National Association of Real Estate Investment Trusts (nareit.com) publishes investment returns for real estate investment trusts.

they know. When individuals don't know much about the various ownership and management risk associated with different types of property, he suggests that they look for investment opportunities where they are not locating, negotiating, and managing the properties.

When an individual wants to "control" the real estate and isn't interested in partnerships, Alexander advises that they chose credit worthy commercial opportunities preferably with net lease features or land, because they aren't as management intensive and the risk is easier to assess.

Alexander reports that the majority of his clients who own real estate outright are putting the real estate in LLCs to segregate the risk associated with each of the ownerships. Petersen reports the same for individuals who invest in single family, duplex, or small rental properties, as most also use LLCs for liability purposes. For those that acquire property-commercial and rental-as an income source, besides setting up separate entities to own the property, Hoffman recommends the purchase of substantial umbrella insurance (\$5 million minimum in coverage).

He favors owning any building outside the business entity not just for legal liability concerns, but also for tax reasons. "If the property is purchased in a C corporation and sold at a later date, all profits would be trapped in that C corporation, and the sale would create two tax events," Hoffman explains.

Petersen often has to deal with clients who hold too much real estate. His objective is to get them diversified to other assets, such as stocks and bonds. Another problem that some of his clients face is they don't have a diversified portfolio of real estate, so that they are over-dependent on one particular property and its cash flow.

"Most of our clients have all their eggs in

one basket, so if we can utilize an exchange to diversify the property flow, then you leverage to better manage risk," he explains.

Hoffman believes that most people should for asset allocation purposes have some investment in real estate, and he finds that the less-sophisticated investors on the wealth management end, about 90 percent of the time, have no real estate in their portfolio when they first come in.

### Cap Rate and Other Cautions

Alexander believes that you make or lose your money on real estate when you buy it, and observes most income-producing real estate is bought and sold based on a capitalization rate. He gives the following example: If a piece of real estate is sold at a seven percent cap rate and it generates a net operating income of \$100,000, then the property will transact at \$1,428,571 (\$100,000 divided by seven percent). This means if a buyer paid all cash for the real estate and the income remained the same, the buyer would be satisfied with a seven percent return on his cash based on his perception of the risk associated with this real estate.

He adds, "Some people think that real estate naturally goes up in value. This isn't true. The cap rate is affected by interest rates. When interest rates are low, then cap rates tend to get lower because the 'cost of capital' is cheaper.

When interest rates increase, cap rates tend to increase as well. Our investor purchased the property described above at a 7 percent cap rate for \$1,428,571 and now wants to sell his property, but interest rates and cap rates have increased and the prevailing cap rate for his type of property is now 10 percent.

If we assume that the net operating income is still \$100,000 then he can sell his property today for \$1,000,000 (\$100,000 divided by 10 percent). Given the current rising interest rate environment, I am concerned

that some people are going to find out that real estate doesn't always increase in value."

Hoffman also pays particular attention to the cap rate, and advises studying it closely so as to not overpay. He also advises to generally stay away from large buildings with one tenant.

Olson has an important caveat about investing in real estate. "We simply can't overemphasize the importance of thorough, well-planned property specific due diligence in the investment/acquisition process." Alexander warns, "The key to real estate investing is having enough resources (cash) to ride out changing markets. The interest rates and cap rates will continue to change. The folks with sufficient resources to wait for the change usually fair well in the long run."

He adds, "Most people recognize that leverage (debt) enhances returns. It also increases the risk of failure." His advice is to be sure to structure the debt so that the investor won't have to liquidate the holdings in an unfavorable market.

Hoffman indicates that a mistake often made when a business owner is considering a lease/buy scenario is that it turns into a tax-driven decision rather than keeping the focus on the economics of the deal.

Another mistake that Hoffman sees with non-seasoned investors is buying at top of the market and not adequately considering the costs of maintenance and repairs, or the impact of the loss of tenant. Murray cautions against speculation, and indicates that certain markets are just too high. A mistake she finds, especially in the purchase of a second home, is people buying more than they can afford thinking they can flip the house at a higher value in a short time.

### The Ultimate Advantages

Despite these cautions, there are obvious advantages to investing in real estate. Alexander believes it is a great inflation hedge and is negatively correlated to bonds or other fixed-income products in most cases. And, according to Petersen, "The nice thing about real estate is you can invest the income return in some other asset on an annual basis and still have the appreciation."