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Determining if your cap-rate is a critical component when analyzing to keep your investment holdings

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The capitalization rate or cap-rate is a ratio used to estimate the value of income producing properties. Determining your cap-rate is a critical component when analyzing your investment real estate holdings. If you're lucky enough to own an investment property earning a 10% cap-rate, you probably have a piece of real estate well worth keeping.

To determine your cap-rate, refer to the Schedule E of your latest tax return. Â Simply subtract your expenses from your income - then divide this number by the equity in your building. Â For example, if your net income (after expenses) is \$50,000 on a building which has a market value of \$1.25 million where you have a \$250,000 mortgage, subtract the mortgage due from the market value: Â \$1.25 million - 250,000 = \$1 million Â Divide the \$1 million equity figure into your net income (\$50,000), which gives the cap-rate of 5%. Â Such a cap-rate can be improved upon by selling the property and buying institutional quality real estate through a 1031 exchange. Â Many investment property owners in New England today have cap-rates as low as 2 or 3%. They are not able to cash in on the appreciation they've enjoyed on their real estate in recent years. Â Such investors should consider exchanging their property to provide higher income streams. Â I usually advise clients to consider selling their real estate if their cap-rate is below 6%. Â Even at 6%, if remaining tax advantages via depreciation are minimal, the owner can consider selling.

Once a determination that selling a property should be beneficial to the owner - whether because of management headaches or simply to improve the investor's income, we offer clients several tax-efficient alternatives, the most popular are:

*Charitable Remainder Trusts: The investment of choice for eliminating capital gains taxes before modern 1031 exchanges became available. Â I still recommend them for clients who need income tax deductions or have charitable goals. The property is donated to a trust that provides income to the donor for life. No capital gains are paid on the transfer to the trust, but income taxes are due on the trust income. Â An income tax deduction is available for the initial donation.

*Deferred Sales Strategy: Improved version of the old private annuity trusts, which are now obsolete. Â Major benefit is it provides tax deferral for more than one generation and may immediately remove value of property from the taxable estate. Â It also allows flexible investment choices.

*Structured Sales: Allows an immediate sale with tax deferral in exchange for lifetime of income guaranteed by an insurance company. Â Appeals to those who want to avoid real estate, interest rate, and stock market risks.

*1031 Exchanges for accredited investors (those with a net worth over \$1,000,000) - An exchange

of one investment property for another can help improve cash flow. Taxes from the sale of the property are tax-deferred. However, another larger local property still may involve substantial management tasks. Accredited Investors who wish to purchase professionally managed property have several alternatives:

***Tenant In Common (TIC):** These institutional quality, professionally managed real estate investments have been increasing in popularity since the IRS released a favorable revenue ruling in March of 2002. We have been successful placing clients in a variety of TIC investments throughout the United States. These allow clients to diversify geographically, and through a variety of property types. Popular TIC real estate opportunities can be found in the office, industrial, apartment, and retail real estate segments, with cash flow usually around 6-7%. Even raw land can be configured to provide income for TIC investors with a low Minimum investment of about \$100,000.

***Natural Gas/Oil Wells:** These 1031 exchanges entail less risk compared to traditional exploratory oil & gas investments. The IRS considers these investments real property, and thus the ability to invest via a 1031 exchange. Royalty Income may exceed 10% per year for 30-50 years, while working interests in Natural gas/oil wells may pay 10-30% per year, but have a shorter lifespan. Both are custom made for 1031 exchanges. Minimum investment requires around \$50,000. Some of our clients elect to invest a percentage, say 20% of their 1031 money into higher-income producing gas/oil wells, while investing 80% of their exchange funds into traditional real estate. We offer complementary consultations for real estate owners. We have extensive experience and expertise in all the solutions listed above and more. Real estate brokers are also welcome to work with us.

Ronald Birnbaum, CLU, ChFC, CASL is co-host of "The Financial Consultants with Birnbaum & Burwick" Monday-Friday at 7a.m. on WBIX, 1060 AM.

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