

TIM'S LAW #3

BUY YOUR OWN BUILDING

IF YOU ARE A BUSINESS OWNER, odds are you are either working from your home, leasing office space or you own the building which houses your business. In tough economic times, the contraction of the credit markets and declining real estate values create opportunities to acquire commercial properties at fantastic values.

It's a proven fact that the greatest component of most Americans' net worth is the equity in their home. This same concept applies to business: the greatest component of a business' fair value, or net worth, is often the real estate it owns. For small businesses, the net worth of the business passes through to become the net worth of the owners of the business. In more than twenty years of advising clients, I have assisted the purchase or start-up of dozens of businesses, helped to grow these businesses and have come full circle to sell some of them. When the time came to sell, and there was real estate involved, the overall consideration received by the seller for the dirt represented a substantial portion of the total sale.

An excellent illustration is the story of Robert and James. They were long-term employees of a pipeline construction

company and, in 1991, had the opportunity to buy the company. I was on the team that represented them in the transaction and arranged financing for the deal. The total price paid for the business, including the real estate which housed the company headquarters, was approximately \$2,200,000. Over the next eight years, the business grew until it attracted the attention of a large publicly traded company and I again represented Robert and James, this time in the sale of their company. They received \$6,500,000 for the business and **kept the real estate**, leasing it to the new owners. Five years later, I sold the real estate for the partners. The total proceeds for the real estate was \$2,200,000, the amount they originally paid for the entire company. Throughout the period Robert and James owned the company, the real estate served time and again as collateral for loans to enable them to continue to grow the business. In the end, the real estate turned out to represent one fourth of the total money they made on the ultimate sale of the business. Though their goal was to buy the business, the dirt underneath turned out to be the part of the deal with the biggest payoff when they exited the business.

*Remember: the economy in the early 90's was not good. The nation had just gone through declines in the real estate market associated with the savings and loan bailouts of the late 80's and early 90's and real estate values were depressed. **Robert and James seized the opportunity presented by the down economy and ultimately became millionaires.** Today Robert and James are retired to their respective estates: Robert is in the scenic Blue Ridge Mountains in North Carolina, and James is sticking his feet in the Gulf of Mexico from his beachfront home in Florida.*

Let's bring the story forward to 2008 and learn the tale of Mark and Kristi, who I predict to be among the next generation of millionaires on my client list. Mark and Kristi are in their early thirties and both started their careers with a major hotel chain in the hospitality field. Kristi was an event planner and Mark was an executive chef. In 2004, they left the hotel chain to form a management company to run a special events facility. Their contract with the ownership of the facility entitled their management company to a percentage of the profits and Mark and Kristi earned an excellent living over the next four years. However, they were still basically working for someone else in a facility they didn't own. The housing market tanked, credit tightened up and folks began to cut back on weddings, which are the staple of most special events facilities. The opportunity to buy the facility from its owners came up and, after much agonizing, Mark and Kristi decided to go for it. I assisted them with this transaction and they bought the business and the real estate at approximately two-thirds of what it was worth, for \$2,300,000. They got such a good deal on the purchase they were able to get 100% financing from their local bank, not an easy task in the 2008 banking climate. The real estate represented approximately 65% of the transaction. I'm sure we will be hearing good things about Mark and Kristi in the future.

I would be remiss if I didn't reveal one of my personal moves during this down economy. While most of the media attention has been devoted to the residential housing bubble, the effect of downward pressure on real estate values has been felt on commercial properties as well. Often a residential developer also has commercial projects and, when the housing bubble bursts,

all are affected. I found one such situation in Lawrenceville, Georgia. An office condominium park was partially complete when its developers went under and the remaining unsold properties were foreclosed upon by a bank. Once a property becomes bank-owned, it usually is not well maintained as most banks are not in the business of property management nor do they want to own real estate. Their goal is to get the property off their books as soon as possible. The property consisted of one completed unit, two units approximately 90% completed, and five building lots.

With a little research of public records, I learned the bank had originally loaned approximately \$1,500,000 on the properties, had foreclosed, and sent them to the courthouse steps for auction. At the auction the bank did not get a suitable offer and bought the property back for approximately \$1,200,000. This number told me what the property was worth in the current market. (In Georgia, in order for a lender to pursue a borrower for a personal guaranty, a lender must attempt to sell the property for fair market value before looking to the borrower/guarantor for the difference).

I inspected the properties and determined they were in reasonably good shape with mainly cosmetic issues that could be addressed. The bank listed the entire package with a commercial realtor for \$700,000. I offered \$600,000; the bank counter-offered \$650,000, and we settled at \$620,000. Sure enough, when I got my appraisal for the bank financing, the appraisal was \$1,200,000. **Because I was buying the property at such a discount from what it was worth, my lender financed the entire transaction with no money down.**

Now, what am I going to do with three office condos and five lots? I already have an office and don't need another. I plan to sell them to business owners who are currently renting and want to own their own building at a great deal. The plan goes something like this: buy at 50% of the property's worth, sell to a business owner at 80% of its value and develop a program with my lender to finance these business owners with little or no money down. Typically a bank wants twenty percent down of whatever the purchase price is or original cost. Sometimes a lender will loan on **current appraised value**. If the deal is priced at 80% of what it is worth and a lender will loan 80% of what it's worth, no money down is needed. Even if your lender will not do 100% financing, there are creative ways to work with the lender and the buyer to get the deal done.

Remember: think outside the box!

That leads to the story of Lorna and David, two independent insurance agents with two separate rented office locations. They were tired of paying rent for two locations and wanted to consolidate offices in a building they would own. They had excellent credit and good cash flow, but did not have any money for a down payment. Using the above plan and a "can do" attitude, we were able to work together to make it happen. To help them with their down payment, I took part of the sales proceeds and put them in a certificate of deposit with the lender for one year. After a year, if all goes well, the bank will release my CD. The alternative was for me to do a second mortgage. I did not want to be in the lending business and this plan allowed me to tie up money for one year instead of twenty, helped get Lorna and David into their office building and made the bank comfortable

enough to do the deal. Everybody won and the beauty of it all is that Lorna and David's note payment is twenty-five percent less than if they had rented the building they purchased. It was not an easy decision for Lorna and David due to the economic environment and the doom and gloom projections for the economy, but they decided to go for it. I will be writing about them in a future book about millionaires.

An example of an industry where the dirt is almost always worth more than the business is the day-care industry. In 1995, Daniel and Kate, both in their mid-30's, decided to go into business for themselves. Daniel was a middle manager in a transportation company and Kate was a homemaker. They loved kids, had friends in the day-care business and, after much diligence, they selected a national franchise and signed on. Their initial investment was \$1,400,000, financed with a Small Business Administration loan. Today, the business is worth around \$700,000 and the real estate approximately \$3,000,000. Daniel and Kate plan to continue to run the business and they are comfortable with the knowledge their retirement is secure.

Then there is the story of Darrin. Darrin is in the bar and restaurant game in coastal South Carolina. In 1991, he bought an old house across from hotels on the beach for \$140,000 and converted it into a restaurant. The restaurant has performed well over the years and generates a steady cash flow. But again, the real payoff is buried in the dirt: appraised value of the property is currently more than \$1,000,000.

The number one reason to own your own building is financial and it will become one of the primary components of your net worth over the long haul. **Depending on the real**

estate market, the value of your building can double every seven to fifteen years. Equity in the building can be used to finance working capital needs, equipment needs, to acquire a competitor or any number of other business financing needs. Secured real estate financing typically is less expensive than shorter-term loans such as working capital lines of credit, equipment financing, receivables financing, or floor planning.

While the primary reason for owning your own building is financial, there are non-financial reasons to own your building as well. There is nothing quite like the feeling of unlocking the door of a building with your name or your company name on it in the morning before the rest of your employees get to work. That's when you will reflect on your career and how you got to where you are. The simple turning of a key in a door lock will bring to you in a flash your beginnings, your struggles, your successes, your failures and your hopes and plans for the future. When we moved into our brand new office building, which I built, one of my young twenty-something year old staff accountants said, "Must be a good feeling to own your building. It says something about our firm." He's right. If the kids can figure it out, those of us with a little more seasoning ought to be able to do it also.

A nice, well-maintained office building, warehouse or shop sends a message to employees, clients, competitors and suppliers that you have "arrived." It's not enough to simply have title, but the location needs to be maintained and decorated to reflect your personality and comfort zone. More often than not, I find that business owners will spend more effort and money on making a place they own look good as opposed to rented space.

I also find the things people like in their homes tend to show up in their places of business. I'm no different. You will find the same color schemes in my home as you do in my office. Most of us in business spend more time in the office than at home and like to be comfortable in our surroundings.

As a practicing CPA, I would be remiss in not pointing out the **tax aspects of owning your building. The mortgage interest, real estate taxes, property insurance and maintenance expenses are all deductible.** Additionally, **depreciation** expense can be taken over the life of the building (Most office buildings are depreciated over 39.5 years under the current tax code. If you have a \$1 million building, that equates to approximately \$25,000 a year in depreciation). The depreciation applies to the building cost only. Land is not depreciable. However, sidewalks and parking lots are depreciable over a shorter period of fifteen years. If you plan to own your building for more than five years and the total cost of the building is more than \$750,000, a cost segregation study may be of benefit to you. With a cost segregation study, an engineer reviews plans and schematics from building construction to determine if some of the components can be classified as property with a shorter life. For example, if you own a print shop and have a commercial printer which needs more than a standard electrical outlet, the cost of the wiring for this outlet can be treated as part of the printer and depreciated over five years instead of 39.5 years. I caution you with this approach as any depreciation taken will be "recaptured" as ordinary income when the building is ultimately sold. In essence, depreciation is a tax deferral as long as you own the building.

There is also the matter of how your building should be titled or what type of legal entity should be the legal owner of your building. I do not recommend owning any type of business property in the name of an individual for liability purposes. We plan for worst case scenarios by putting your real estate in some type of legal business entity; personal assets are shielded from any number of bad things that can happen in the world of business.

The choice of business entity generally is limited to corporations, partnerships or limited liability companies. Let's rule out corporations right off the bat. **Never, ever put anything that will appreciate in value in a corporation.** There are some very onerous tax consequences if you want to sell the property or have need to transfer title of the property out of the entity for any reason. That leaves partnerships and limited liability companies. **A general partnership offers no liability protection** and I recommend avoiding those entities. A limited partnership typically has one general partner and one or more limited partners. This type of entity is effective if you have a family partnership involved in the ownership of the building. For most of us, **the limited liability company is a flexible entity for tax planning, provides protection of personal assets, and is generally the best and most popular choice of entity for owning real estate** for a variety of reasons. A limited liability company can be taxed as a corporation or a partnership for federal income tax purposes and, in general, you want to be taxed as a partnership for federal income tax filings. **My favorite structure for tax purposes is to have the real estate owned by a limited liability company and the operating company**

to be a subchapter S-corporation. The S-corporation leases the land and building from the limited liability company. The entrepreneur/business owner owns both entities.

Note: A full discussion of the choice of entity for owning real estate is beyond the scope of this book and I urge you to consult with your attorney and accountant on what's best for you.

There are deals to be had in commercial real estate during economic downturns. I have shared my own success stories and those of some of my clients, outlined strategies, and provided basic advice on taxes and choice of entity for owning real estate. The opportunities to buy your own building are out there. Do your research and carefully select your property. Who knows—I might be writing about you in a future book.