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THE BAUER REPORT

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Controlling Property With Purchase-Option

Some investors look for the short-term investment with less of an emphasis on "doing business" and more pre-investment research on controlling property for the maximum gain in the short term. These investors often use the option or purchase-option.

Traditionally, most real estate investors have been attracted to commercial real estate opportunities. Typically these investors have been well rewarded for their investment. Properties that are designed for "doing business" proliferate and succeed as businesses grow and diversify and become more and more profitable. For investors to be successful it is normally important to understand the operation of the particular commercial enterprise involved in the real estate investment.

Control With Purchase-Option

A purchase-option contract lets the buyer-optionee purchase a property at a specific price within a certain period of time. If the option is exercised, a closing is held and the property is purchased at the price previously agreed upon. There is no legal obligation to buy the property. But, if the optionee does not exercise the option, the deposit paid to the seller-optionor is forfeited.

The biggest differences between the purchase-option and direct ownership may be two advantages from the viewpoint of the investor: **First**, the short term (6 to 24 month) purchase option contracts can be an outstanding way to control property without assuming the responsibilities of ownership. **Second**, the contract enables the optionee to receive all of the benefits from appreciation in market value of the property.

Benefits Of Basic Responsibilities

There are five basic responsibilities of property ownership that are eliminated by using the purchase-option contract:

Long-term Commitment. With many investments, there will be no cash profit from property ownership until the property is sold. With the purchase-option, the responsibility for a long-term commitment of ownership is eliminated. The optionee's commitment is short-term only, with the ability either to sell the option, buy and immediately sell the property, or never buy the property.

Mortgage Payments. There are no mortgage payments made by the optionee. He has eliminated

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November 2019

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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.

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the responsibility to "pay for" the property during the period when the purchase-option is open and unexercised.

Property Management. There will be no responsibility with respect to managing and maintaining the property unless the optionee exercises the option and takes possession of the property. In a straight purchase, the buyer must begin maintaining and managing the property right after closing–a time consuming and costly responsibility.

Cash Payments Required. As we all know, property ownership involves payment in full or cash down payment (10% to 25% or more). When the property is controlled with the purchase-option, the down payment is replaced by an option deposit (the consideration in the contract) that can be in a much smaller amount, perhaps in the 1% to 5% range.

Financial Liability. Optionees have no financial risk in the property other than the amount paid in the option contract. The property owner must pay the property taxes, mortgage payments, insurance payments, maintenance and repairs and any other obligations of ownership.

The optionee has the specified period of time that is in the term of the option in which to buy the property or decide to pass. During the time, the optionee can evaluate the potential and make those decisions. It is certainly the best way to hold a property for an increase in value over a very short term. ❑

Cooperative Land Development

The acquisition and improvement of land is a large-scale operation and requires large amounts of capital. This has created methods of land acquisition that gives the developer access to and control over a large enough tract to make development economical without requiring an initial outlay of all of the capital necessary to acquire such a tract. From the point of view of the landowner, the disposal of a large tract at a good price may require a formula that will encourage the developer to commit improvement and development money for part of the tract that will build future value into the entire tract.

This may be accomplished by the following:

- The developer sets up a master plan that sets forth the general scheme of development and submits it for the approval of the owner.
- The developer and owner enter into an agreement setting forth the acreage prices for the entire property.
- Owner and developer agree on the number of years over which the full development is to be completed.
- To protect the owner against freezing of his property, the developer firmly commits to buy a predetermined number of acres each year.
- If the developer fails to meet this schedule, the owner is released from his commitment.

A Development Agreement

Another way of handling the problem is for the developer to share the net profits from the land development with the landowner. This can be done by a "land development agreement" in which the developer agrees to perform the platting, the laying out, the installation of lot improvements, and the promotion of the subdivision. The landowner agrees to accept a percentage of the sales price of each lot, with a fixed minimum guaranteed. For example, the developer agrees to pay net to the landowner 25% of the sales price of each lot sold, with a minimum of $50,000 per lot.

With this kind of arrangement, it is important to protect the landowner from finding his land cluttered up with liens left by a subdivider who went broke. The landowner should consider confining the developer or subdivider to a small tract of land at a time and give him "rolling options" to acquire additional parcels at intervals over a period of time. Failure to keep up with this purchase program results in loss of future options. The land that has been optioned but not purchased is not subject to liens against the developer.

A Liability for Not Proceeding

In one case, a jury found that a village breached its contract with a real estate developer calling for the village to acquire property and convey it to the developer for construction of apartment houses and a shopping center, all conditioned on obtaining financing from HUD. The village repudiated its explicit undertakings, to acquire and convey property to the developers. HUD had granted the main application and was in the process of considering the other grants involved, so the village could not back out of its promise. [Heritage Commons Partners v. Village of Summit, 730 FSupp 821, (ND Ill. 1990)] ❑

Warehouses —A Great Investment

When Syndicates, partnerships, investment companies and their individual participants look at investments in commercial properties, many tend to look at properties that have that bewitching charm of glamour in brochures. A beautiful office building or an enclosed shopping center seem to have a more acceptable "status" as an investment property. These buildings can be nice to drive by and point out as "our" investment.

Originally, any property designated as a "warehouse" would always be located in areas zoned for industrial use. There is not nearly as much allure in a squat bulky warehouse building. The physical attractiveness is not there in color flyers and photographs. However, as money makers, these bulky buildings can be a very profitable real estate investment.

A recent check in one area showed a vacancy rate in distribution warehouses of 4% to 6%, while office buildings had a 10.7% vacancy level. The vacancy rate for warehouses remains low in good times and bad. If there is a slump in demand for real estate, commercial real estate should not be affected. The demand for space in warehouses should remain the same.

When choosing a site for a new facility installation, think first of the renters who will be your customers. Does the warehouse have easy access from a major highway or Interstate? Will the driveways and parking areas accommodate large trucks? Is the facility very close to any houses or residential areas that will complain about the noisy trucks?

Expenses and Income

The normal costs of operating any rental property are the utilities, insurance, property taxes, management and maintenance.

Access and parking are important. There should be direct access to each unit by a vehicle with multiple trailers. There should be room for these vehicles to turn around or be passed by another car or truck. Loading docks are provided at most commercial-oriented warehouses.

Security: The latest state-of-the-art equipment makes the convenience of round-the-clock access available with no loss of security. There can be computer-controlled entry gates and individual alarms in each unit with security cameras installed in various places around the facility. If the building is a conversion of an existing property, windows should be sealed. All entrances and exit doors should be barred and locked. Building a new facility is easier, with fences, electronic gates and alarms built in originally. ❑

Real Estate Investment Guidance

Which way is the right way in real estate investments in 2020? What is the future in these investments? An answer to these questions can be an interview with an interested professional real estate broker who can act as a real estate investment counselor. Each prospective investor can be interviewed in depth to find out specific needs in an income property. At the same time their needs are being evaluated, the broker will also communicate what benefits are available in various properties and how to identify them.

Some considerations should be given to the risk of loss for each age bracket of investor. Should an older investor purchase a property with the smallest down payment and highest leverage position? This will limit cash flow and may cause the property to have a "negative" cash flow. Is this what they want – or do they want cash flow from the property?

How about the younger investors? Are their objectives for long-range estate building or for current cash flow? Would they be more willing to take chances with a marginal investment that might bring big returns later?

Each investor must decide these answers for himself or herself. But, only after enough information has been furnished so that an intelligent decision can be made.

When a new investor has a better idea of the type of property that will do the right job for him/her, or them, then and only then should they be exposed to the market place and shown specific properties. Now the investor or investors can evaluate the various benefits and risks for the information shown on each property and apply the information to their own situation.

What is right for you? An industrial building, A Warehouse, A new rental unit, An office building, A strip center, A one hundred-unit apartment property? Perhaps you should have five or six apartments or commercial properties in scattered locations. Real estate counseling can show you that you can choose which is right for you and know the reasons why it is right! ❑

Costly Mistakes In Real Estate

Investors sometime make investments in real estate that turn out badly. They 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. ❑

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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A CCIM is a professional real estate practitioner with proven technical expertise in commercial property. A CCIM is a person truly committed to the fundamentals of effective commercial-investment brokerage. The CCIM has completed a full schedule of Post Graduate Level Courses in investments, taxation, development and marketing all types of commercial-investment properties. The designation of Certified Commercial-Investment Member is unquestionably the highest degree awarded in the commercial-investment real estate practice.