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Option Gives Seller More Capital Gain

A buyer is interested in buying raw land from a seller and offers a good price provided the seller will take back a 100 percent purchase-money mortgage with the entire principal due at maturity and with no personal liability.

The seller counteroffers to change the transaction to a long-term option. The consideration for the option will be paid periodically by the buyer in an amount equal to the interest that otherwise would have been payable on a purchase-money mortgage. Option payments would not be credited against the purchase price if the option were exercised. Because the purchase price would be the same under either approach and because the option fee would equal the interest, the consideration paid by the buyer would be the same.

If the purchase-money mortgage were used, the seller must treat the interest as ordinary income. However, using an option (and assuming the property is a capital asset in the seller's hands) changes the result. The seller does not need to report the option payments as income at the time received. Any tax

on these amounts is deferred until the option is exercised by the buyer or expires. If the option is exercised, the payments then become capital gain, taxed at the capital gain rate. If the option expires, the option payments retained by the seller are taxed as ordinary income (and he keeps the property).

The Tax Court has upheld this approach against initial strong IRS objections; however the IRS subsequently agreed in the decision of *Carl E Koch v. Comm'r* (67 TC 71 (1977). Acq. 1980-1 CB 71).

Koch granted a prospective purchaser an option to purchase large land holdings in Florida for \$11 million. The option was to continue for five years provided an option payment was made each quarter equal to 1.5 percent of the purchase price (6 percent a year). Koch did not report the option payments as income during the ➔

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This publication is not a solicitation but is an information service from this office.

In This Issue

- Option Gives Seller More Capital Gain
- Alternative Uses For Distressed Real Estate
- Negotiating The Sublease
- Help With Investment Real Estate

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.

Option Gives Seller More... (continued)

years when the option was outstanding.

The IRS made the following three arguments, all rejected by the Tax Court for the reasons given:

1. Because the payments were a percentage of the option price, they were really interest (just as if a purchase-money mortgage had been created). However, there was no debt, so there was no interest.
2. The transaction was actually a series of three-month options, and as each option expired, the option fee became income. However, a five-year option had been specifically entered into.

3. Because the option payments could not be credited against the purchase price (if the option was exercised) the payments were immediate income. However, because the seller could easily have raised the purchase price if the option payments were to be offset against the price, this factor was not significant. (Note that in the previous example, it was assumed that the option payments would not be credited against the purchase price.)

If an option is used, the buyer loses a tax deduction for interest paid on a mortgage. Instead, the option payments become part of his costs for the property if he exercises the option, or a capital loss if he does not. □

Alternative Uses For Distressed Real Estate

No matter how good or bad the market may be in commercial real estate, there is always distressed property of some kind. Some are so bad that the best solution is to demolish. There might be hope for a turnaround in a property by a change in use or change in market for its use. Here are examples:

- Change of use.
- Change of ownership form.
- Providing more benefits for buyers or tenants

Changing Use

One change is one that stays close to the original use of the building but tries to appeal to a different type of buyer or tenant than the original owner aimed for. As an example, an apartment property could be remodeled to combine space in small apartments to form fewer but larger units for which there could be a greater demand.

On the other hand, dividing apartments into smaller, less expensive units makes sense when the demand in the area is concentrated in single or no-children households. Adding some inexpensive amenities might make the building more attractive. If zoning is right,

adding medical offices or boutiques on the ground floor could add appeal.

Changing the use should not be done without a current demographic study to determine if a market for the renovated space exists.

The Hotel Conversion

One type of property has successfully made a conversion in some locations. The residential-style commercial property or apartment property located in a commercial or industrial area can be difficult to rent. The solution can be conversion to an extended stay hotel. Many conversion opportunities exist in downtown locations. The property must be located close to feeder business that attracts extended-day business travelers.

To attract the five-or-more-night guest, the hotel should provide the following: (1) studios and one and two bedroom suites that are larger than the standard hotel room; (2) a fully equipped kitchen; (3) a private outdoor entrance; and (4) at least a minimum amount of public space, including meeting rooms and restaurants.

Some large hotel chains have built or converted nonhotel properties into residential hotels that primarily serve travelers staying for five or more nights. Rental or condominium apart- ➔

Alternative Uses... (continued)

ment buildings as well as retirement communities are examples of the types of properties that might be suitable for conversion.

Office and Bank Buildings

Bank buildings can be surplus because of the many mergers in recent years.

Office buildings may be vacant because of the movement of some businesses to the suburbs. Because these properties usually are in excellent locations, they are candidates for conversion.

Office buildings that are designed for smaller tenants can be suitable for residential use because many of the office units approximate the size of apartments.

They may not be suitable for industrial or warehouse use because the structural support for that use may be lacking.

The banks and thrifts often

have large floor space. These can be easily converted to restaurant use, retail or a public facility. The high ceilings in banks can be appropriate for adding a mezzanine level to increase the amount of usable space.

Form Of Ownership

The second alternative is to consider changing the form of ownership of the property from rental to a cooperative or condominium. Although the great majority of tenant-owned properties are residential housing units, there are many office buildings, retail facilities, industrial units and other commercial properties that have been converted to tenant ownership.

It may seem that units would be difficult to sell in a poor rental area. However, the payments and expenses may be only slightly higher than rent and the benefits of equity build-up, de-

preciation, interest deductibility and possible appreciation may make purchasing very desirable.

Incentives

Before giving up on the property, try some give-aways. After all, this is the most frequently used marketing tool without changing the use. These incentives could include:

- Rent abatements.
- Additional amenities
- Reimbursement for tenant improvements.
- Paying a new tenant for moving from another building, and assuming that lease.
- Offering tenants some sort of equity sharing in the future of the building.

Of course, if all this fails, you gave it your best shot. Remember the first option, demolish it! □

Negotiating The Sublease

With changes in business strategies in the 2000's, some existing tenants wanted to sublease all or some of their rented office space to eliminate some locations and shrink operations in others. In this situation, the problem for landlords is whether it is a better strategy to enforce lease restrictions against subleasing or to work with tenants on the theory that the sooner cheap sublease space is filled, the better for all. (In

addition, another problem could be whether landlords should insist on sublease restrictions in new leases being negotiated now.)

Lease Restrictions

If there is no provision against the sublease in the original lease, the tenant has the right to assign or sublease without the owner's consent or approval. However, most leases do contain this provision. In the mid-1990s, when rents were at high levels, tenants

could obtain the landlord's consent only if no other space was available in the building, and even then, the landlord might have insisted on sharing in any profit realized on the sublease. (In those days, sub-rent was often higher than the prime rent.)

At this time, few tenants are trying to sublease for a profit. Instead, they are interested in cutting costs of unused space and are often willing to accept →

Negotiating The Sublease...(continued)

current market rents, something landlords are reluctant to do for prime space.

Cooperation Between Landlord and Tenant

Although the building owner may take the position that no consent will be given to a sublease as long as prime space is available in the building, the tenant may make some good arguments for cooperation.

First, when there is much space available all around, a tenant looking for space can find it easily. A landlord is better off having a tenant in possession, even with a sublease, because the tenant may stay when the sublease expires.

Second, the landlord takes the risk that a prime tenant with much excess space may default

under the lease either by being forced out of business or because the tenant is willing to risk a lawsuit to collect unpaid rent. By being cooperative in finding a subtenant, the landlord reduces the risk of a default by the prime tenant and has the additional security of the subtenant's rent payments (even though the amount may be less than the prime rent).

Perhaps most important, the landlord may gain the reputation for good tenant relationships that can help in the competitive years ahead. Helping the tenant to shed excess space can pay off when the tenant considers renewal of the present lease. Landlords who are known for taking a reasonable approach to tenant problems, both during and after lease negotiations, are bound to have an edge when a tenant must make a choice between very similar rental space in different buildings. □

Help With Investment Real Estate

When you have searched for new real estate investment opportunities, with values that have been changing, you know that finding and evaluating them is becoming more sophisticated and complex. More investors are turning to real estate consultants as a means of providing a sounding board for their ideas as well as expertise in the planning and construction stages for their projects.

Today's investor in real estate must have a grasp of market conditions and potential that is usually beyond their own available time to attain. Investors need assurance about the true condition of the market. With increased competition, the market place is becoming more complicated.

Feasibility studies are essential for commercial office, industrial, resort and hotel investors. With this kind of information, planning is better and

there is less chance for error.

Real estate investing is not just looking for the structure and the land. It is investing in the type of property that you want at the price and terms that suit you at the time you want to make the purchase.

Our office is open and ready to assist you. We have been experts in property values in this area for a long while. We can help you with enough information so that you can make your own decisions on the value of property either in listing your present property for sale or in purchase of another. If you wish to consider structuring a tax deferred exchange into that next property, we can guide and aid you with that transaction.

Let us guide you in your investments. □



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.