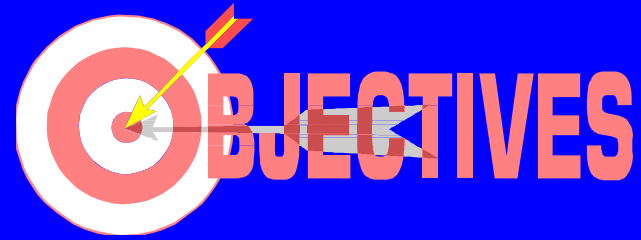


# CHAPTER 15

## Investment Overview and Specialized Operations

# Chapter 15



1. Recognize client needs
2. Analyze an Annual Property Operating Date Report
3. Name and define investment terminology
4. Explain how depreciation is calculated
5. Describe the elements of a 1031 exchange
6. Discuss various specialized brokerage operations
7. Discuss various alternative careers within the real estate industry

## A. CLIENT needs

- Increasing net worth: appreciation, equity growth.
- cash flow: CASH income less expenses.
- tax savings: Reduce tax liability.
- pride of ownership: Intangible benefit.
- leverage: Using the money of others to magnify the return on your investment

# JARGON

- Pencil out: Averting “negative” cash flow. The income supports the expenses.
- APOD: Annual Property Operating Data
- Break Even: The income equals the expenses. Threshold.
- Return “ON” Investment: The income generated from the amount invested in the property
- Return “OF” Investment: The return pay back of the amount invested in the property (Recapture)

## B. APOD

- vacancy/credit: Management determines
- utilities: Tenants determine usage
- repairs/maintenance: Current and deferred
- taxes/insurance: Reassessment, Special assessments, Automatic increases
- debt service: Loan payments

# C. Investment Terminology

- Capitalization rate (Cap Rate)
  - Value = NOI/Cap Rate
  - Value = \$24,000/8%
  - Value = \$300,000
- Cap Rate yield rate =
  - Return on the investment (interest rate) AND
  - Return of (recapture of the principle invested) the investment
- internal rate of return (IRR)
  - Stated as a percentage; requires using present value tables or a financial calculator

## C. Investment Terminology

- Gross rent multiplier (GRM)
  - $GSI \times GRM = \text{Value}$
  - $\$2,000 \times 150 = \$300,000$
- Net operating income (NOI)

GSI	\$48,000
– <u>Vacancy</u>	<u>- 6,000</u>
= EGI -	= \$42,000
- <u>Operating Expenses*</u>	<u>- 18,000</u>
= NOI	= \$24,000

OE = TIMMUR

## D. FORMS OF depreciation

For tax purposes: Decrease in value of an asset.

Forms of depreciation:

- Physical: Wear & tear, aging (building structures over 50 years old).
- Functional: Change in style, technological advances (Ex: wood heating stoves; 4 bedroom, 1 bath home).
- Economic: Factor outside the property, over which the owner has no control (freeway; closed plant).

# DEPRECIATION CALCULATIONS

- Physical = First separate land and improvement value. Then divide the improvement value by 27.5 years for residential, 31.5(39)years for commercial. This is the annual allowable depreciation. Then add back the land value.
- (IRS does not allow depreciation on the value of the land.)
- Functional = Actual cost of renovation or cost to remedy the obsolete improvement/fixture/feature.
- Economic = Dollar cost or percentage loss attributable to item being considered.

# Residential Property Depreciation

Property Value	\$300,000
Land Value	<u>-100,000</u>
Improvement Value	$\$200,000 / 27.5 = \$7272.72/\text{yr}$

## Income Tax Calculations:

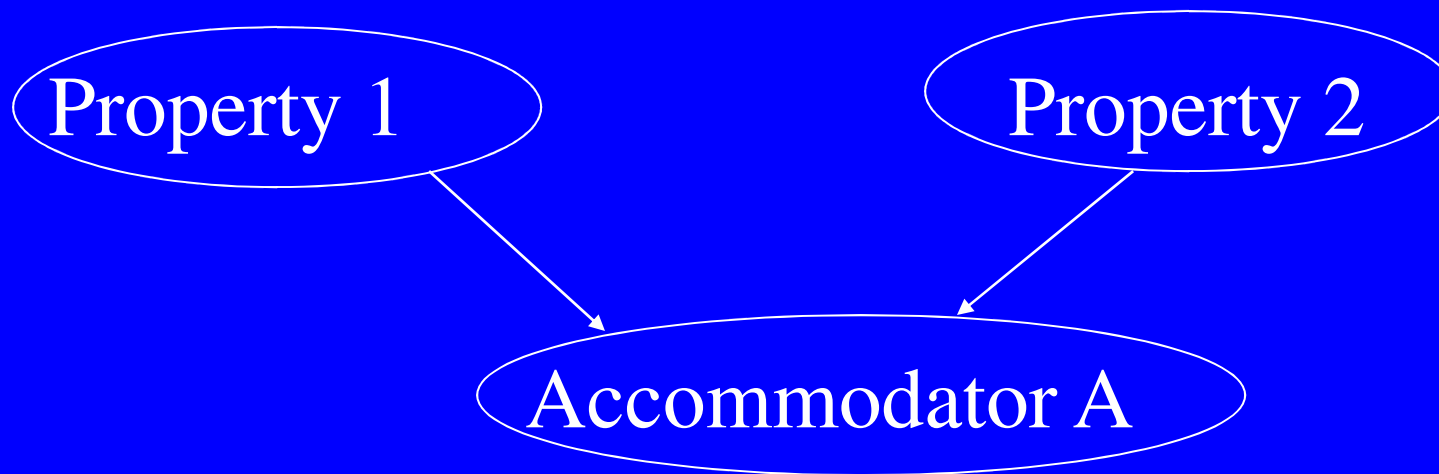
GSI	\$48,000
Vacancy	<u>- 2,500</u>
EGI	\$45,500
Operating Expenses	<u>- 21,500</u>
NOI	\$ 24,000
Interest Expense	- 18,000
Depreciation	<u>- 7272</u>
Taxable Income/Loss	<\$-1,272>

## NOTE:

Actual positive  
cash flow is  
\$6,000 per year

Owner writes off  
Negative \$1272  
against other  
taxable income

## E. TYPICAL 1031 EXCHANGE ARRANGEMENT



- “like kind” PROPERTY: Refers to usage (Ex: the property produces income), not to the type (residential, industrial or commercial).
- Does not eliminate taxes, it defers (postpones) the obligation to pay.

# IRC 1031 Exchange

In a Starker Exchange:

- **45** days to “identify” property being purchased (may identify several and then choose one).
- **180** days to close escrow on the new property after date of close of escrow on sale property sold.

reverse exchange:

Allows you to buy of a new property before selling the old property.

New property is “parked” with qualified intermediary (accommodator until old property closes escrow.

The exchange **MUST** close within the 180 days. Pg 151

# Why use an exchange?

- Preserve equity
- Avoid capital gains taxes
- Acquire property without using cash
- Trade one property for several other parcels
- Increase depreciation and basis
- Relocation or expansion
- Retain investor status
- Build an estate
- Reduce property management problems
- Increase income flow

# Investing

- Risk versus Return
- Cash flow versus Income
- Liquidity
- Management
- Tax shelter
- Leveraging
- Appreciation
- Depreciation
- Pyramiding

# F. SPECIALIZED BROKERAGE

- Commercial sales and leasing
- Industrial sales and leasing
- Property management
- Mobile homes sales
- Business opportunities
- Loan brokerage

## 2. BUSINESS opportunities

- Uniform Commercial Code (UCC): Security transactions in personal property.
- Bulk sales: Transfer of goods, supplies & equipment (UCC, Division 6)
- Alcoholic Beverage Control Act (ABC): For businesses that sell for consumption alcohol. (UCC, Division 9)
- Board of equalization: Responsible for collecting and accounting for sales tax. A “Clearance Receipt” assures no Successor Liability.

# CONSIDERATIONS IN SELLING A BUSINESS OPPORTUNITY

- Determine a seller's motives to sell
- Ascertain buyer's motives to buy
- Licensee's responsibility to the buyer
- Good will as part of contract

# Government Agencies involved in Business Opportunity Transfer

- Internal Revenue Service
- State Board of Equalization
- State Department of Benefit Payments
- State Department of Industrial Relations
- Board of Health
- OSHA
- Police and Fire Departments
- County & municipal agencies for permits and licenses

# 3. Mobile Home Regulations

- Business & Profession's Code citations
- DRE Commissioner's regulations
- Health Code
- Commercial Code
- Revenue & Taxation Code
- Civil Code
- Administrative Code
- Local zoning ordinances
- Mobile home park rules

# DRE LICENSEES & Mobile Homes

- DRE Licensee: Mobile homes that are:
  - registered with Dept of Motor Vehicles or Dept of Housing & Community Development for more than 1 year
  - Affixed to a foundation:
    - Mobile is then considered real property for:
      - Taxation
      - Sale
      - Lease
      - Financing.

## 4. Property Management

- Acts as the agent for the owner
- Manages rental income property
- Specialized training
- Accounting of income & expenses
- Leasing
- Overseeing maintenance

# Alternative Careers

- Loan Brokerage (See Ch 13)
- appraisal
- escrow
- title insurance
- right of way agent
- development & Construction
- Architecture, Design, Planning