



How a “Financial Physical” can help determine when to dispose of multifamily investment property - by Russell Gullo

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A “Financial Physical” shows owners of multifamily investment property how they can double, triple, and in some cases, even quadruple the size of a real estate investment portfolio by using their current equity. This is possible with the use of leverage and Section 1031 of the Internal Revenue Code, which is the opportunity to pay no tax when disposing of income-producing, or investment held property through a 1031 exchange.

The intent of a “Financial Physical” is to emphasize that equity grows from the time of acquisition of an investment property throughout the holding period due to the principal pay-down of a mortgage and the increase of value through appreciation. By using a 1031 exchange, you can dispose of your current property and couple 100% of your new equity position with leverage to acquire a larger investment property or portfolio of properties. This allows you to increase the size of your real estate investment portfolio by simply using your current (increased) equity position.

A “Financial Physical” also determines how “healthy” your current property or properties are performing from a cash flow perspective. As you know, there are two types of cash flows associated with any income-producing property: Cash Flow Before Taxes (CFBT) and Cash Flow After Taxes (CFAT). The CFBT (with “T” referring to income taxes) should increase over the holding period as rents are increased, but the CFAT, when measured on an after-tax return basis, will diminish as time goes on. As you go through the holding period of your real estate investment, the interest expense portion of your debt service decreases, allowing you to shelter less cash flow while your depreciation expense remains the same or decreases. This concept is proven by dividing your CFAT by the current equity position in your subject property today. (You must use your equity position today and not the equity used at acquisition). The summary is that it doesn’t matter how much money you make (CFBT) but how much money you keep (CFAT). In some cases where individuals are mortgage free and fully depreciated, they may have no tax shelter and Uncle Sam can take as much as half of their cash flow each year, depending on their tax rate. These individuals are giving up one of the four basic benefits of real estate investment: tax shelter.

Another benefit of a “Financial Physical” is that it can help determine when to sell your asset as your annual after-tax return reaches a point where the risk vs. return ratio no longer meets your financial comfort level. As a rule of thumb today, this usually happens between five and ten years. As previously mentioned, the after-tax return typically diminishes the longer you hold an investment property. This can be proven by using any cash flow analysis program/software.

Finally, a “Financial Physical” can also be used to show an investor how to increase cash flow (both CFBT and CFAT). This can be accomplished by upgrading their real estate holdings and disposing of an investment property that is producing a diminishing rate of return on an after-tax basis. With the use of leverage (other people’s money) and Section 1031 of the Internal Revenue Code, you have the ability to increase your cash flow, and in most cases, also increase the size of your real estate investment portfolio by using your additional equity growth from equity build-up and appreciation.

In summary, if you want to know how “healthy” your multifamily investment or portfolio is, you should consider having a “Financial Physical” conducted to maximize your holdings.

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