Commercial Classroom: Land – To sell or land lease - by Ed Smith

November 02, 2021 - Long Island

This column is offered to help educate agents new to commercial and investment brokerage and serve as a review of basics for existing practitioners.

The value of land generally increases over the long term. Your client, who purchased an acre of commercial land 20 years ago for $50,000, wants to sell it. What advice should you give them?

Over the years, the location may have built up and today the property is worth several hundred thousand dollars. But under today's tax laws, if they sell it, they will most likely have to pay considerable capitals gains taxes. (The amount will vary based on their income bracket.) Let's say the land sold for $350,000, with a net to the owner, after commissions, legal fees etc., of $325,000. The combined federal and state capital gains could be $55,000 or more.

Let's say the seller sold the property, paid the capital gains taxes and now has $270,000 left to invest. One option would be to put the money into a bank account or mutual funds, which may yield them a 1-2% annual return.

Or they could use the money to finance the purchase of an office building, retail center or multifamily investment, which would require 30-40% down, 5 % for closing costs and a small reserve for repair. The Return on Investment (ROI) would be based on market conditions, the buildings cash flows and debt service costs. Initial ROI may be low but over time it would be expected to increase, the buildings value would appreciate, and ownership has significant tax advantages (deductions for building expenses, real estate taxes, depreciation, and mortgage interest).

Another opportunity would be to do a 1031 exchange. The property is sold, and another property is purchased to replace it, typically of higher value. In an exchange, the capital gains tax is deferred to the newly purchased property. Many rules apply. In this case your client would need the advice of a 1031 exchange specialist, a qualified intermediary.

Buying a building with the net cash after taxes or in a 1031 exchange has advantages and risks. Generally real estate is a good investment in the long run. You may achieve a 7-8% or even higher annual ROI, while the equity increases, and the building appreciates in value.

Another tax strategy would be to sell the property and the seller finances the purchase, holds a mortgage note, creating an “installment sale.” This defers some of the capital gains taxes as they would only be due on the principal collected each year. But the interest on the mortgage loan is also taxable as income.

The other alternative is to land lease the property. With a land lease they do not have to pay capital gains taxes. As a “rule of thumb,” a land lease generates 10% of the market value of the property in rent each year. A property worth $350,000 to sell would land lease for $35,000 per year in rent. It is important to note land leases are usually “triple net,” meaning the tenant pays all the expenses of the property. The tenant is also responsible for the cost of constructing a building on the site. Land leases today are typically 49 years long, with increases in the rent every five years.

Which is the best situation for your client? Present all the options and let them decide. The real comparison is to look at the cash flow that remains after the annual income taxes are paid. Recommend to your client that they consult with their accountant or tax advisor.

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