



Should I Own My Own Building?

By Patrick G. Beckner, Broker

I have been asked this question by many business owners as they consider their lease or purchase options. They often have paid rent for several years and realize that they have not built any value for themselves. Instead, they have helped their landlord build equity in the building(s) where they leased. Many regret that they haven't already purchased their own property and been building equity. Almost every business owner should own their own property at some point in time. The issue is when and how. We will discuss below the advantages of owning a building, but we will also be discussing the issues that must be considered.

The Advantage of Personal Ownership

Business property ownership is one of the last tax advantages open to the small business owner. Most company owners are advised to own the property personally using a Limited Liability Company (LLC) formed specifically for that property. The company then leases space in the building from the LLC. The company is able to deduct the lease payment as a normal business expense. The owner through the LLC shows the rent as income but is able to show the interest and any expenses as deductions. In addition the owner (LLC) is able to depreciate the building which gives him further tax advantage. The company pays market rents and is able to therefore move money to the owner (LLC) with reduced tax obligation. The building is also not shown as a liability to the company since they are leasing the property. In the future the owner (LLC) will be able to sell the property and the equity gains will usually be taxed as recapture or long term capital gains which are both taxed at rates lower than simple income. In addition, the property could be sold as a part of 1031 tax differed exchange and the equity moved to another property with no immediate tax liability. An additional economic advantage regards rental rates. Since the company owner is now the landlord he can stabilize the lease rate for as many years as he wishes. The company may never again have a rental rate increase. This is a major advantage to ownership. On the other hand the company owner as landlord can increase rental rates over time and increase the cash flow he realizes through the LLC. Either way the company owner benefits from his control of rental rates. An investor in real estate has three primary ways he can make money. They are cash flow, appreciation, and reduction of debt. All three are available to the company owner through the LLC. The company is paying no more than in a lease and the company owner is reaping the additional rewards.

There are advantages to ownership beyond the financial rewards discussed above. The owner can now control more directly the operating expenses of the property. He can decide when and how various maintenance issues are addressed and thus present the image he desires while controlling costs. Further, he controls his environment from temperature control to tenant finish. The improvements now belong to him and not the landlord. This allows the owner to look at improvements with a long-term view. Improvements that might not be prudent in a short-term lease are now considered

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reasonable over a longer term. If the building has other tenants the owner can now control who those tenants are and their behavior.

A perceived disadvantage of ownership is the long-term nature of loan debt. Owners tend to think that they could be trapped in an ownership position that would limit their options. This is a perceived situation in that the owner can sell the property whenever they desire or they can lease the property to another tenant. In a lease the lessee is committed for the entire term of the lease and the monthly rent is just a payment plan. The lease generally has a “total lease obligation” and then agrees to accept monthly payments per a rent schedule. If the tenant decides he wants to move his only options are to sublease the space (generally at a substantial loss) or to try and “buy out” the lease. There is little motivation for the landlord to work with the tenant. On the other hand the value of a building is based on the income from the tenant or from the current market value of the building. This gives the owner two options – either stay as a tenant and do a “sale-lease back” deal or vacate the building and sell to an owner/user. The major danger in ownership is that the owner needs to move due to the inability to make the loan payment. But if he can’t make the loan payment he will also have difficulty making the lease payment. The upside of ownership is significantly better than in a lease and the downside is not much different from a lease.

Disadvantages of Ownership

Building ownership does not make sense for everyone. The major disadvantage is the down payment required to purchase a property. The business owner will need to tie up significant funds in a building. They will not be available to fund the growth of the company. Depending on the type of loan, an owner should expect to have to make a 10%-20% down payment. Thus owners with significant capital needs probably should not commit funds to a building. Although a building should appreciate in value it does not provide liquidity.

Similarly, businesses that are growing rapidly should be cautious about purchasing a building. If the owner can project that he will outgrow the building in a relatively short time, he should probably delay purchasing until his growth is stabilized. This can potentially be handled by buying a larger building and leasing a portion of it to other companies. An ideal situation is when the additional lease can be coordinated with the owners needs. This provides the owner with expansion and rental income. But, the owner must be able to carry the building if he loses the tenant.

Should I Build a Building?

Many owners feel they have special needs that can best be met by constructing a new facility. One which provides them the greatest efficiency in design and allows for the unique work flow of their company. Generally, it costs more to construct a new building than to purchase an existing building. This is similar to the difference in costs between a spec house and a custom home. Although more expensive a custom building may actually result in a gain if it increases the profitability of his company. Usually, we assist a client is a search of existing properties before we move towards a custom design.

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But, if their needs are unique or there is not an existing property that meets their needs, we work with our clients to design and construct a custom building.

The Unseen Advantage of Building

We have worked with many clients to custom build a new facility. We always tell them that the effect on their business will be greater than they can expect. In every instance their business has grown significantly. It seems that during the construction process the company and owner are seen with new respect by both employees and customers. The process creates an excitement in the company that appears to invigorate the employees. Similarly, customers, banks and other business associates view the company with greater respect. Their perception of the company is changed. Building a custom facility seems to communicate “we have arrived.” We can not say we understand the process but we have seen it over and over again.

Conclusion

Building ownership is advantageous for most established company owners. They receive real value for their lease payments. They also often reap increased business activity. Thus, the decision to own is both a real estate decision and a business decision.