BUILDING VALUE

Small Investors Are Poised To Become Heavy Hitters

By RAY A. SMITH
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Some small investors are moving into the big leagues.

Prompted by low interest rates, a number of small investors looking to boost their real-estate payoff are buying larger properties, valued at more than $5 million, by selling smaller, less expensive properties and taking out a loan. While trading up to more-expensive properties can lead to higher profits, it can also lead to hefty capital-gains taxes on the sale of the less-expensive property.

Some investors, though, have found a way to put off that tax bill indefinitely.

The way to do that, brokers and financial planners say, is the 1031 exchange. That's where owners typically defer capital-gains taxes on the sale of a property by exchanging it for one of equal or modestly higher value. But with interest rates so low, investors are getting more ambitious and "trading up" to bigger, more expensive properties.

Investors using 1031 exchanges often pay for a higher-valued one by selling one or more properties and getting a new low-interest loan. Doing so means the investor doesn't have to come up with as much cash out of pocket to purchase the property. With low interest rates, an investor can sometimes trade up and still pay the same amount, or not that much more, in monthly mortgage payments as on the original property. Investors can keep swapping property and never pay a tax bill until they sell their property and get out of real estate altogether.

(In most cases, a third party prepares the exchange agreement and handles the money. The property the seller wants to buy has to be identified within 45 calendar days of the sale and purchased within 180 days.)

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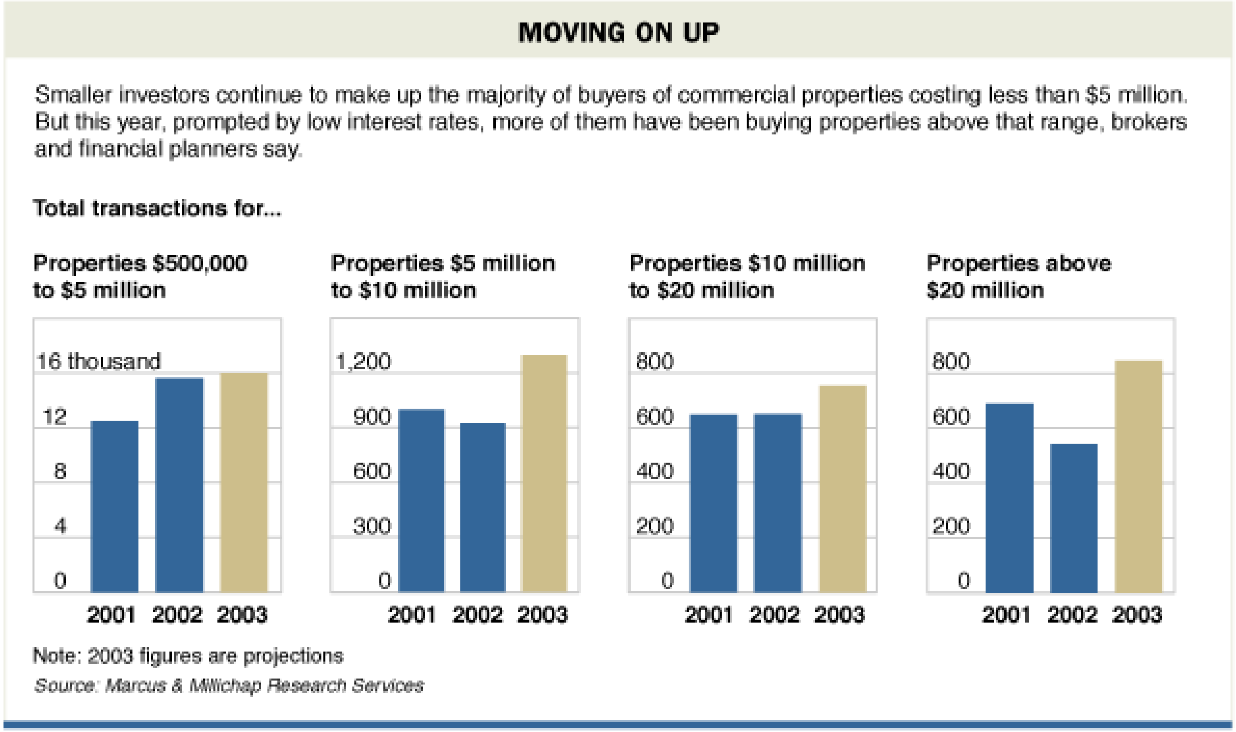

Besides the favorable rate environment, there are plenty of reasons to trade up. Investors get higher tax deductions for depreciation because the asset's value is higher. Owning more-expensive properties also gives smaller investors access to more-established tenants -- such as corporations -- that can afford higher rents.

There are some disadvantages. A small investor with a number of smaller properties can spread the risk out if a tenant in one of those buildings defaults, for example. But if a similar situation happens in a large asset that takes up most of the portfolio, that investor doesn't have enough diversification to offset the risk, says Gary Woodworth, a broker in the Indianapolis office of CB Richard Ellis, a Los Angeles commercial real-estate services firm. "If someone goes into a bigger single asset, they're limiting their diversification," he says.

Also, larger assets can be harder to fill when a tenant's lease expires or if the tenant goes bankrupt, especially as demand for larger chunks of space remains weak.

What's more, an investor can run into trouble if interest rates rise, says Joseph Murtagh, a financial planner in Goshen, N.Y., since commercial property loans are typically adjustable-rate mortgages. If rates rise, the investor "will have a higher debt service that may be more than they're comfortable with," he says.

Another thing smaller investors should be mindful of when investing in bigger properties is higher expenses, warns Jeffrey Harwood, a money manager with Abacus Wealth Management Inc. in Pacific Palisades, Calif. He recommends asking the owner of the property or a broker about typical expenses.

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