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Controlling Property With Purchase-Option

Some investors look for the short-term investment with less of an emphasis on "doing business" and more pre-investment research on controlling property for the maximum gain in the short term. These investors often use the option or purchase-option.

Traditionally, most real estate investors have been attracted to commercial real estate opportunities. Typically these investors have been well rewarded for their investment. Properties that are designed for "doing business" proliferate and succeed as businesses grow and diversify and become more and more profitable. For investors to be successful it is normally important to understand the operation of the particular commercial enterprise involved in the real estate investment.

Control With The Purchase-Option

A purchase-option contract lets the buyer-optionee purchase a property at a specific price within a certain period of time. If the option is exercised, a closing is held and the property is purchased at the price previously agreed upon. There is no legal obligation to buy the property. But, if the optionee does not exercise the option, the deposit paid to the seller-optionor is forfeited.

The biggest differences between the purchase-option and direct ownership may be two advantages from the viewpoint of the investor: First, the short term (6 to 24 month) purchase option contracts can be an outstanding way to control property without assuming the responsibilities of ownership. Second, the contract enables the optionee to receive all of the benefits from appreciation in market value of the property.

Benefits Of Basic Responsibilities

There are five basic responsibilities of property ownership that are eliminated by using the purchase-option contract:

Long-term Commitment. With many investments, there will be no cash profit from property ownership until the property is sold. With the purchase-option, the responsibility for a long-term commitment of ownership

November 2017

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is eliminated. The optionee's commitment is short-term only, with the ability either to sell the option, buy and immediately sell the property, or never buy the property.

Mortgage Payments. There are no mortgage payments made by the optionee. He has eliminated the responsibility to "pay for" the property during the period when the purchase-option is open and unexercised.

Property Management. There will be no responsibility with respect to managing and maintaining the property unless the optionee exercises the option and takes possession of the property. In a straight purchase, the buyer must begin maintaining and managing the property right after closing–a time consuming and costly responsibility.

Cash Payments Required. As we all know, property ownership involves payment in full or cash down payment (10% to 25% or more). When the property is controlled with the purchase-option, the down payment is replaced by an option deposit (the consideration in the contract) that can be in a much smaller amount, perhaps in the 1% to 5% range.

Financial Liability. Optionees have no financial risk in the property other than the amount paid in the option contract. The property owner must pay the property taxes, mortgage payments, insurance payments, maintenance and repairs and any other obligations of ownership.

The optionee has the specified period of time that is in the term of the option in which to buy the property or decide to pass. During the time, the optionee can evaluate the potential and make those decisions. It is certainly the best way to hold a property for an increase in value over a very short term. ❑

Warehouses —A Great Investment

When Syndicates, partnerships, investment companies and their individual participants look at investments in commercial properties, many tend to look at properties that have that bewitching charm of glamour in brochures. A beautiful office building or an enclosed shopping center seem to have a more acceptable "status" as an investment property. These buildings can be nice to drive by and point out as "our" investment.

Originally, any property designated as a "warehouse" would always be located in areas zoned for industrial use. There is not nearly as much allure in a squat bulky warehouse building. The physical attractiveness is not there in color flyers and photographs. However, as money makers, these bulky buildings can be a very profitable real estate investment.

A recent check in one area showed a vacancy rate in distribution warehouses of 4% to 6%, while office buildings had a 10.7% vacancy level. The vacancy rate for warehouses remains low in good times and bad. If there is a slump in demand for real estate, commercial real estate should not be affected. The demand for space in warehouses should remain the same.

When choosing a site for a new facility installation, think first of the renters who will be your customers. Does the warehouse have easy access from a major highway or Interstate? Will the driveways and parking areas accommodate large trucks? Is the facility very close to any houses or residential areas that will complain about the noisy trucks?

Expenses and Income

The normal costs of operating any rental property are the utilities, insurance, property taxes, management and maintenance.

Access and parking are important. There should be direct access to each unit by a vehicle with multiple trailers. There should be room for these vehicles to turn around or be passed by another car or truck. Loading docks are provided at most commercial-oriented warehouses.

Security: The latest state-of-the-art equipment makes the convenience of round-the-clock access available with no loss of security. There can be computer-controlled entry gates and individual alarms in each unit with security cameras installed in various places around the facility. If the building is a conversion of an existing property, windows should be sealed. All entrances and exit doors should be barred and locked. Building a new facility is easier, with fences, electronic gates and alarms built in originally. ❑

Knowledge About Tax Deferred Exchanges

The following are points that participants in a tax-deferred exchange should keep in mind when starting an exchange transaction:

- Even though an exchange may be tax-free at the federal level, it may be taxable at the state or local level.
- One party to an exchange may qualify for tax-free treatment even though the other party does not.
- There is no limit on the number of exchanges an investor can make.
- Corporations can make tax-free exchanges.
- When sale of a property would produce a loss, exchanging normally does not make sense because the loss will not be recognized for tax purposes.
- It is legal to make an exchange solely to save taxes.

Under Code Section 1031, which provides for tax-deferred exchanges of property, no gain or loss is recognized on an exchange of real estate where:

(1) property held for productive use in a trade or business or (2) property held for investment purposes is exchanged solely for like-kind property **to be held** either for productive use in a trade or business or for investment purposes.

Once all requirements of a tax-deferred exchange of like-kind properties are met, the tax deferment is mandatory. Taxable gain is deferred until such time that a taxable disposition occurs.

The properties that are exchanged can either be investment properties or business properties or both investment or business properties. Thus, real estate held for productive use in a trade or business can be exchanged tax-free for other properties held for productive use in a trade or business or for investment.

Likewise, real estate held for investment can be exchanged tax-free for other real estate held for investment or for other real estate held for productive use in a trade or business.

Neither real estate which is stock in trade nor real estate held primarily for sale can be exchanged tax-free. Other properties which cannot be exchanged tax-free include property being used as a personal residence and not held for investment by its owner, certificates of trust or of beneficial interest, and other securities or evidence of indebtedness or interest.

The essential elements and characteristics of a tax -deferred exchange of like-kind properties are as follows:

- The transaction must amount to an exchange of properties; it cannot be a sale or some other transaction.
- The properties must be of like kind.
- The properties must be held for productive use in business or for investment purposes.
- The properties cannot be stock in trade or property held primarily for sale.

If an exchange otherwise qualifies but includes as part of the consideration for the exchange money or property that does not qualify, the transaction qualifies, but the tax-free treatment does not apply to the money or other property that does not qualify.

If an exchange otherwise qualifies but, as part of the consideration, the other party assumes liability or acquires property that is subject to a liability, the transaction qualifies, but the tax-free treatment does not apply to the assumption of the liability or the liability to which the property is subject.

Once an exchange is completed, the property received cannot be held for resale or as a personal residence if tax-free treatment is desired.

Where an exchange qualifies for tax-free treatment, neither parties to the exchange nor the government can treat it otherwise than as a tax-free exchange.

Deferred Like-Kind Exchanges

A federal court decision in 1979 introduced the concept of the deferred exchange and thus expanded the scope of the tax-free exchange provision in the tax law. Congress then amended Section 1031 of the code by adding subsection (a)(3) giving statutory approval to the deferred exchange but imposing certain limitations.

Example: Arthur and Baker agree to exchange like-kind properties. Arthur already owns the property he is to exchange and transfers title to Baker. In exchange, Baker agrees to transfer to Arthur some time in the future a specified property (or type of property). If Baker does not acquire the property, Baker will pay the price in cash. Except for the fact that the exchange of properties is not simultaneous, the exchange meets all of the requirements of Section 1031.

Two time limits must be met under the Section:

1. The property to be received by Arthur must be identified as such no later than 45 days after the date that Arthur transfers his property to Baker. The replacement property must be identified in a written document signed by the taxpayer and delivered (by hand, mail, or telecopy) to the person involved in the exchange like the seller of the replacement property or the qualified intermediary before the end of the identification period. However, notice to an attorney, real estate agent, accountant or similar persons acting as your agent is not sufficient.

2. Arthur must receive the property from Baker no later than the earlier of (1) 180 days after Arthur transfers his property to Baker or (2) the due date of Arthur's tax return for the year in which he transfers the property to Baker.

The 180 day rule has two potential traps. The rule is expressed days, not months, so the parties must count the number of actual days after the transfer of the first property. Also, the second property must be actually transferred. Merely signing a binding contract is not enough.

The one point that is clear is that the party who is to receive the identified property cannot receive cash (either actual or constructively) and purchase the property himself, since this violates the basic requirement of a tax-free exchange. ❏

Costly Mistakes In Real Estate

Investors sometime make investments in real estate that turn out badly. They may then blame the loss on the "real estate cycle" when there were mistakes that could have been avoided by better planning and analysis. Based on data obtained through interviews with more than 200 real estate practitioners, several costly mistakes were identified and discussed. Here are three of them:

Misjudging demand. Developers have faced costly setbacks by assuming that customers existed without undertaking adequate market analysis. For example, a retail development designed to attract shoppers from executive ranks in the adjoining commercial center failed to realize that high-income executives have demanding work schedules and tend to shop during their leisure hours near their suburban homes. Clerical workers, who might shop during lunch or break periods, cannot afford up-scale store prices.

Faulty property analysis. Investors invite catastrophe by failing to thoroughly examine all physical aspects of property improvements, including size, structural stability, and mechanical systems. Some investors have suffered losses by relying on ballpark estimates of rehabilitation costs or by purchasing multi-unit buildings after seeing only representative sample units carefully selected by sellers.

The investment fallacy. Too many people have equated real estate investment with a more passive "buy low, sell high" investment in assets such as stocks, gold, and stamps. They have failed to recognize that time, talent, and work must go into maintaining and enhancing a property's value. They have failed to understand that income properties and "investment" properties are largely the fruits of imaginative and capable management. ❑

Commercial Real Estate Representation

There are a number of ways to buy, sell or exchange investment or commercial real estate. Having the knowledge of what you can do in some tax situations can be the difference between an annual profit or loss in a property that you intend to acquire or one that you already have in inventory.

The professional commercial real estate broker is in the position to represent clients in real estate transactions by setting up sales, exchanges, leases, purchase and sales of options, and management of real estate.

A professional real estate practitioner must stay aware of current tax laws and court decisions in order to structure transactions, but does not give legal or tax advice (unless he/she is also an attorney or a certified public accountant). In any complex transaction that might result in changes in any owner's legal or tax situation, the other members of the "consulting team" should be the owner's attorney and CPA. We always recommend meeting with these other professionals during the planning and closing of major real estate transactions.

As commercial brokers, we are part of your professional team. It is our job to create the real estate transactions that will be needed to enhance your estate. We should meet with our clients on a regular basis to evaluate their present position in properties, reviewing plans for future acquisitions or exchanges.

Reviewing your plans and goals can give us the information needed to help us in moving you in new directions as soon as possible, using purchases, sales or tax deferred exchanges. ❑