

Deaton Investment Real Estate's **Investment** REAL ESTATE REPORT SEPTEMBER 2008 for the Triangle, Triad and Eastern North Carolina

News, notes and available
properties from
North Carolina's
Apartment Market



WHEN IT'S TIME TO SELL, KNOW HOW TO SELL PROFITABLY:

Exit strategies for apartment owners

Deaton strives to help apartment owners execute the most profitable investment strategies possible. In this effort, we have interviewed some of the most experienced professionals in the areas of tax strategy, 1031 Exchanges and passive ownership to help you learn more about the most beneficial exit strategies when selling property.

Part I: Innovative Finance and Tax Strategies for Entrepreneurs and Investors with Kevin Bassett of Bassett & Associates, PA

Q: If I decide to sell my property for cash, how much should I expect to pay in taxes?

A. Capital gains rates are 15% federal and the North Carolina tax rates can be as high as 8.25%. So together the rate is roughly 23%. This is the case unless you are subject to the Alternative Minimum Tax (AMT). The AMT rate is 28% federal, so your total rate could be as high as 36%.

Q. So how do I figure out how much of the sale is subject to capital gains tax?

A: Capital Gains taxes apply to the difference between the original purchase price plus what you put into it and the sales price minus selling expenses. This is what is sometimes referred to as the tax on the appreciation of the property. If you have depreciated the property, you must "recapture" that portion at your ordinary federal rate which could range from 10% to 35%.

Q. A potential buyer asked me if I could provide owner financing on the sale. Are there any tax advantages of doing so?

A. Yes. This allows you to treat the sale as an installment sale so you can recognize your gain over time as you receive payments.

Q. Are there any disadvantages to owner financing?

A. The obvious disadvantage is that you don't get all your cash up front. The other disadvantage is that you still have to pay tax on the depreciation recapture in the year you sell. Therefore, it may be important

to get a large enough down payment to pay those taxes.

Q. I've heard a little about Charitable Remainder Trusts as a way to sell my property and avoid paying taxes. What is a Charitable Remainder Trust?

A. It's an irrevocable trust where the investor is usually the income beneficiary for life. The remainder interest in the trust (what's left over in the trust when the investor dies) goes to charity.

Q. What are the advantages of a Charitable Remainder Trust?

A. The big tax advantage is that you can completely defer capital gains by moving your property into the trust before you sell it. You don't pay capital gains tax on the sale and you can reinvest 100% of the proceeds (not the after tax proceeds) into some sort of cash flow investment and receive an income stream for life. In addition, you also get a tax deduction for a percentage of that future charitable deduction on your current tax returns. Instead of paying taxes, you are actually saving taxes and you are reinvesting with pre-tax dollars.

Q. What are the disadvantages?

A. You can not get your hands on the money after you put it in the trust without paying a penalty, so you've got to be OK with just the income stream for life. The other disadvantage is that the money does not pass to your heirs when you die.

Q. Is there any solution to that problem?

A. Yes. You can create an asset replacement trust by using the tax savings in the first year to fund a life insurance policy payable to your heirs.

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Part II: 1031 Exchanges

with Susan E. Hayden, Esq. of Investment Property Exchange Services, Inc.

Q. What is a 1031 Exchange?

A. 1031 Exchange comes from the Internal Revenue Code Section 1031. That code section in a nutshell says that if you are selling "investment" property and buying "investment" property you can defer the capital gains taxes if you follow certain rules.

Q. Am I really exchanging my property for someone else's?

A. You can but not required. Most exchanges take place where a seller/exchanger sells to one party and then buys at a later date from another party.

Q. What type of property qualifies?

A. To qualify for tax deferred exchange treatment, the property being sold (relinquished property) must be exchanged for property being purchased (replacement property) that is of "like-kind". For real property the "like-kind" requirement is very broad. For personal property the "like-kind" requirement is very narrow.

Q. What are the rules?

A. To avoid the payment of capital gain taxes the Exchanger should follow three general rules:(a) purchase a replacement property that is the same or greater value as the relinquished property, (b) reinvest all of the net exchange equity into the replacement property and (c) obtain the same or greater debt on the replacement property as on the relinquished property. The Exchanger can offset the amount of debt obtained on the replacement property by putting an equivalent amount of additional cash into the exchange.

Q. What are the advantages?

A. The tax dollars saved by doing an exchange can be utilized to purchase additional investment property. By leveraging the amount saved in taxes, a taxpayer can purchase replacement property worth more than if they had paid the capital gain taxes and then purchased.

Q. Can I exchange into a property I already own that I want to improve?

A. No. Any improvements made to a replacement property after the Exchanger takes title are considered "goods and services". These goods and services are not considered "like-kind" property and are taxable.

Q. Can I exchange into my brother's property?

A. The commentators are going to answer that question

"no". Related party transactions must be disclosed to the IRS when filing a tax return on Form 8824. Anyone considering a related party transaction needs to discuss the risks with his or her tax adviser.

****Exchangers should always discuss their 1031 tax deferred exchange transaction with their legal or tax adviser****

For more in-depth information is www.ipx1031.com.

Part III: Passive Ownership Options with Tenant-in-Common and Triple Net Properties (NNN) with Eric Carr of DBSI Securities

Q. What is a TIC?

A. Tenant-in-Common (TIC) is a form of holding title to real property that allows the owner to own an undivided, fractional interest in an entire property. The interests do not have to be equal. They can be purchased and sold separately from each other. All of the interests added together add up to a total of 100%.

Q. What are the advantages of TICs?

A.The benefits of TIC ownership include the ability to purchase a larger property by pooling money with other buyers, expert due diligence performed on the property and professional management of the investment property by the offering sponsor. As an owner of an undivided fractional interest, owners share portions of the net income, tax shelters and growth. Owners also receive a separate deed and title insurance for the percentage interest in the property and have the same rights as a single owner.

Q. What are the disadvantages?

A.TIC's are not very liquid investments; there is no true secondary market. And, loss of control, as the TIC owner subjects himself to a management agreement to which he has virtually no say in the operation of the property (many would consider this a benefit).

Q. Can I exchange my quad into a TIC?

A. Section 1031 allows a property owner to sell one real estate investment property and purchase another without paying taxes on the gain. Investment properties such as raw land, apartments, houses, office space, and warehouse can be exchanged for each other.

Q. How much money do I need to invest in a TIC?

A. It depends on the property. TIC's are limited to a maximum of 35 investors. Minimum equity investments are based on the total equity needed to purchase the property divided by 35. Typically, minimum equity investments begin around \$100,000.

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16 UNITS

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Deaton.com Keyword: 109ligustrum



20 UNITS - 5 QUADRAPLEXES

109 Ligustrum Court
\$390,000

Deaton.com Keyword: 105photinia



32 UNITS

105 Photinia Court
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Exit Strategies, continued

Q. Can I sell my TIC?

A. It is possible to sell a TIC interest but not recommended. TIC's are not very liquid investments; there is no true secondary market.

Q. How do I get my money back?

A. Once the property sells you will receive your initial investment plus your percentage of any appreciation recognized from the sale. Of course the investor would have to perform another 1031 exchange in order to continue to defer their taxes.

Q. What happens when the TIC sells the property?

A. The same as if you chose to sell it yourself. Once the property sells you will receive your initial investment plus your appreciation percentage.

Q. What is a Triple Net Property?

A. A Triple Net Lease is a lease in which the lessee pays rent to the lessor, as well as all taxes, insurance, and maintenance expenses that arise from the use of the

property. Essentially, a triple net lease allows investors the opportunity to own real estate without the hassles of managing real estate.

Q. How does it differ from a TIC?

A. A TIC is typically managed under a Triple Net lease. A better question is what is the difference between a Proforma Triple Net Lease and a Master Lease? A TIC that is covered by a Master Lease has guaranteed cash flow per the Master Lease agreement, whereas a TIC that is simply covered by a Proforma triple net lease may have fluctuating or possibly zero cash flow. As long as a TIC property is covered by a Master Lease, cash flow to investors cannot be reduced regardless of repairs, maintenance costs, escalating taxes, etc. In a proforma investment, TIC cash flow is paid depending on what the property is cash flowing after repairs, maintenance costs, escalating taxes, etc are paid.

Q. How much money is required to buy a Triple Net Property?

A. Essentially, the same as what's required to invest in a TIC property. ■

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