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Financial Planning for Life

14 Reasons For Owners of Highly Appreciated Property to Use a Delaware Statutory Trust

Dave Lopez
Investment Advisor Representative
Owner, ILG Financial llc
www.ILGFinancial.com
(540)720-5656

Real Estate investing can be extremely rewarding financially. If you have succeeded in your prior real estate investment activities, you may be faced with a new challenge; how do you sell your property without paying income taxes, continue to receive monthly rental income and eventually any appreciation, yet not have to continue taking on the responsibility of property management? The following are examples of when, if you are an "Accredited Investor*", a DST may be the solution you are looking for. Currently, REITs, partnerships and LLCs do not qualify for tax-deferral, but DSTs do qualify.

1. **Retirement Strategy** - Most investment property is currently owned by baby-boomers, or older people. Many of these investors need an exit strategy to fully retire and trade the Terrible T's (tenants, toilets, trash, turmoil) for the Terrific T's (travel, time, tax savings). DSTs provide a solution that enables the investor to list their investment properties for sale where previously they thought they were stuck due to income tax consequences.

Example 1: Our investor (Mary) purchased 4 rental houses 30 years ago for $75k each, depreciated them fully, and now can net $250k each. These can be sold, and tax of $200k could be paid on the gains. The $800k net proceeds can be invested in a 1% CD earning $8k per year. Instead, it may be much better to invest in a DST using a 1031 exchange, the full $1 million may produce cash flow of $40k-$45k per year, no income taxes to pay upon the sale, and the investor still participates in underlying property value gains/losses.

2. **Avoid Financing Obstacles** – Many investment properties currently have debt. This can create a problem if the investor doesn't want to, or cannot qualify for a loan.

Example 2: Mary owed $500k on the 4 rental houses. The full $1 million needs to be reinvested, with at least $500k in new debt. Or, DSTs can be selected with underlying debt in place and the investor will not need to be individually qualified with a lender, won't have to take out a loan, and is not personally liable for any of the debt, this liability is assumed by the DST sponsor.

3. **A Back-Up Plan** – In a very hot real estate market, it is easier to find buyers than it is to find suitable replacement properties. But what if that deal falls through in an attempted 1031 exchange? Mary could have identified up to 3 properties, one being a DST, as a back up plan.

Example 3: Mary found a small office building selling for $1 million as a suitable replacement. Within 45 days of the sale of the rental houses, she identifies this building. She also identifies 1 more property, a DST just in case the deal falls through.

4. **Scraps Approach** – Investor wants to do an exchange as in the previous example, but the office building replacement property is being purchased for $850k, not the $1 million needed for full replacement.

Example 4: By placing the remaining $150k into a DST, this issue is solved.

5. **Maintenance Costs on Older Properties** – Generally, highly appreciated investment property has been held many years, and the structure may be old. Old structures often are saddled with high periodic repair costs, potentially causing risk to owner cash flow.

Example 5: 80-year old Frank called me with questions on his older 69-unit apartment. I asked him how much cash flow he kept per month, he said it was supposed be $6k after debt payments, but in reality, it was zero due to high repair costs. I informed him the DST would be in newer properties, offering initial cash flow of over $12k per month, with repair reserve monies already in place.

6. **Unproductive Real Estate** – 1031 exchanges work in situations involving "investment real estate" for "investment real estate" of any kinds.

Example 6: Frank and Susan own raw land worth $1 million, and pay $15k per year in property taxes, with no rental income. They use a DST to exchange into an apartment building, medical office buildings, and some fully rented self-storage locations. Annual cash flow before appreciation gains are now in excess of $40k per year, instead of losing $15k per year.

7. **Swap Until You Drop** – As we know, using 1031 exchanges simply defers income tax from the sale of real estate. However, there are situations where income tax can be permanently eliminated, and as a side benefit, additional current deductions can be taken.

Example 7: Tom and Teresa are 80 years old *and do a $1 million DST to defer a $900k taxable gain. Eight years later, this DST is sold and their share of the proceeds was $1.25 million. This is rolled into another DST. Tom passed away in the 6th year, and in the 7th year, this DST was sold yielding $1.5 million for Teresa. She can claim the step-up in basis, and eliminate virtually all-taxable gains from this property, as well as depreciation recapture taxes, permanently. She can put the $1.5 million in the bank, with no taxes, or she can do another DST and be eligible to use the new high basis for large depreciation deductions.*

Example 7a: In addition, while they owned the DST, additional accelerated depreciation was taken, reducing their taxes. The sponsor of the

DST providing the accelerated depreciation used a "cost segregation study".

8. **Diversify, Diversify, Diversify** – Owning rental real estate can be great for one person, a financial disaster to another, depending on where that real estate is located. I've witnessed real estate empires tumble due to poor local economies.

Example 8: Bill felt good about the area where his rental house empire was situated, but concerned having all his eggs in a 10-block radius. In addition, prices had appreciated greatly, so he was concerned about being in a new real estate bubble. Using the DST, he is now partially invested in apartment buildings and medical office buildings in 5 different states.

9. **Only 1 "Real Estate" Person in the Household** – Often, married couples are not both wanting to be a landlord. In our example, Fred likes doing it, but knows his 75-year-old wife would not want to deal with rental houses.

Example 9: Rather than run the risk of his wife having to inherit property management duties, a DST took them both out of the property management business, eliminating that risk.

10. **Estate Planning Tool** – Often, beneficiaries of an estate cannot agree on what to do with income properties. In this case, Tom and Teresa have 3 children; one has a drug problem and wants the cash, the other 2 like the income and underlying assets.

Example 10: Once a DST is funded, it's so much easier to take away the liquidation temptation, and potentially manage affairs through the use of trusts for years to come.

11. **A Retirement Plan** – Mike feels like he has 2 houses that are a landlords dream, never a problem, but two others houses are where all his problems originate.

Example 11: Rather than DST all 4-rental houses, he sells only his two "dogs", and keeps the remaining two. He will sell the two "dog" properties as the current renters move out.

12. **Investing Like Buffett** – The local real estate market has been on fire and Mike feels like it may be close to topping out. He originally bought low, now he wants to sell high like Buffett does.

Example 12: Even if the market continues to rise, our investor may see similar appreciation in his new, more diversified real estate portfolio located in other parts of the country.

13. **Fire, Imminent Domain, or Other Casualty** – Rather than doing a 1031 exchange, IRS Code Section 1033 allows for deferral of gains in these cases.

Example 13: Tony had his property forcibly purchased by the county transit authority; another house was lost due to fire. Each of these could use a DST to defer the income tax.

14. **Golden Years** – You have more equity and cash flow than you can spend in your remaining lifetime. What you don't have enough of is time.

Example 14: William has used 1031 exchanges into various DSTs to clear his plate from obligations, improve asset diversification, solidify cash flow, defer or avoid income taxes, and provided a great legacy asset for his spouse and eventually their kids though the use of the DST.

Article written by Brian Evans of Madrona Financial

How can we help?

Like any investment in Real Estate, there are good DSTs and some that aren't so good. Our investment committee is comprised of CPAs who are also Registered Investment Advisor Representatives. Our team has vast experience preparing and reviewing financial statements, so we feel uniquely qualified to analyze the financials from potential DST providers.

We vet the companies, and the individual real estate investments. The investments are run through over 40 data points for analysis such as yield, liquidity, debt to equity, property type, demographics, property age, exit strategy, etc. To invest in a DST, you need to use a licensed investment advisor. We are aligned with your interest to find the best solution in selecting a DST.

For further details you can reach us at:

www.ILGFinancial.com
(540)720-5656
DaveLopez@theilg.com

Disclaimer Notice:

*To be an accredited investor, an individual must have had earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years and "reasonably expects the same for the current year," according to the SEC.

Or, the individual must have a net worth of more than $1 million, either alone or together with a spouse. With the passage of the Dodd-Frank Act, this now excludes a primary residence as being eligible as part of an investor's net worth (investors who had existing accredited investments but who now fail the net-worth test without their residence being valued were grandfathered).

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