PHYSICIANS FINANCIAL SERVICES

ClientAdvisor

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Tap into real estate, not taxes

1031 exchanges, Delaware Statutory Trusts (DSTs), and even reverse mortgages can offer tax-efficient strategies

For successful doctors and other individuals looking to tap into the value of their real estate, a variety of approaches can help access their equity—or even relinquish their holdings outright—without triggering a taxable event.

A **Delaware Statutory Trust (DST)** allows fractional ownership of a portfolio of properties without active management. DSTs qualify for the 1031 exemption, whereby capital gains from the sale of a business or investment property would be deferred if re-invested into a DST within 180 days.

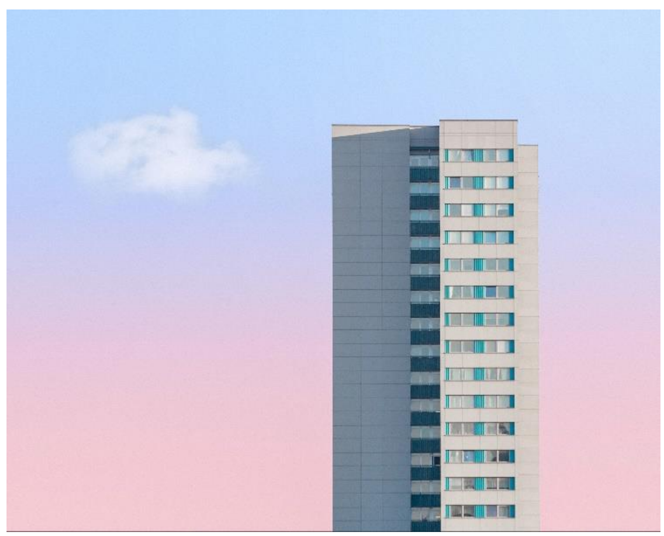
Reverse mortgages are another overlooked solution to tap personal home equity without taxes. These federally insured products allow other assets to maximize accumulation, while interest payments can offset other taxable distributions.

1031 Exchanges Explained

By exchanging property for "like-kind" real estate, successful doctors and business owners relinquishing all or a part of their real estate portfolio may defer taxes if they use the proceeds to purchase replacement property under Section 1031 of the Internal Revenue Code. "Like-kind" real estate includes business and investment property other than the property owner's primary residence.

Several requirements can complicate an ordinary 1031 transaction. Even though the acquisition of new property can take place up to 180 days after the original property is relinquished, a new property (or set of properties) must be identified within the first 45 days, and the final transaction(s) can only involve these "identified" properties. Furthermore, the cash invested in the replacement property must be equal to or greater than the cash received from the relinquished property. Finally, the new property must have the same debt-to-equity ratio, or even more equity than the prior holding. Additional cash can make up for a shortfall in debt of a replacement property, but additional debt cannot make up for a shortfall in cash. Due to these complications, headaches can arise, and prospective investors should always consult their tax advisors regarding an ordinary 1031 exchange.

Delaware Statutory Trusts (DSTs) as a 1031 Solution



In contrast to an ordinary 1031 exchange, a Delaware statutory trust (DST) permits multiple investors to share fractional ownership in a single property or a portfolio of properties, and nonetheless qualify for a 1031 exchange. A DST takes all decision-making and uncertainty out of the hands of investor and entrusts it with to a sponsor-affiliate trustee.

When a successful doctor or other productive individual sells their real property under such an arrangement, proceeds are escrowed with a Qualified Intermediary (QI). The QI holds the proceeds from the relinquished property's sale in a trust or escrow account so that there is no actual or constructive receipt of the sale proceeds (which would trigger capital gain consequences). The doctor or other individual then receives a beneficial interest in the DST, which pays monthly income, appreciates in value, and can be monitored and managed in an ordinary investment account.

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The DST is the single owner and agile decision maker on behalf of the investors, who have no management responsibilities. Many of our successful doctors have previously enjoyed actively managing a real estate portfolio, but are now eager to trade in these management headaches for passive income in institutional-quality investment properties. Successful doctors and other individuals can even divide their investment among multiple DSTs, diversifying across geography and property types.

Other benefits include: a step-up in cost basis for heirs, but without management responsibilities; insurance against an ordinary 1031 exchange by "identifying" a DST as a backup property to use in the first 45 days; and the elimination of taxable exposure to excess cash from an ordinary 1031 where the windfall does not entirely fit into a new acquisition.

Finally, the DST structure allows our successful doctors and other productive individuals to continue to 1031 exchange real properties without taxable consequence or management headaches for the remainder of their lives.

Reverse Mortgages

When it comes to the *personal* residences of our successful doctors and other productive individuals, 1031 exchanges are not applicable and thus, DSTs are not relevant. Instead, starting at age 62, an overlooked but helpful tool in this scenario is the reverse mortgage.

While having a fully paid off home was the original "gold standard" for retirement, home equity cannot fund investments, bolster savings, buy a vacation home, or be spent on retirement lifestyle. Instead, other assets are depleted to accomplish these objectives while an available source of income is stagnant and unused.

A paradigm shift—especially in an era of rising inflation, market volatility, and low bond yields—requires revisiting the pejorative assumptions and often negative connotations of reverse mortgages. A reverse mortgage loan takes the equity in one's home and turns it into tax-free money. The successful doctor or other productive individual gets to live in the house for as long as they desire. Unlike a home equity line of credit or mortgage, there's no risk of default or foreclosure from missing payments. It's a way to turn wealth our doctors own but can't currently touch into an accessible source to secure and improve their retirement outlook and lifestyle.

As long as the house remains one's primary residence, is maintained, insured, and its property taxes are paid, it can never be "taken away." Federally insured products also ensure our successful doctors will never owe more than the house is worth.

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Interest Payments paired as taxable off-set. Many of our doctors pursue a Roth conversion of money in qualified accounts to remove future tax uncertainty and lock in tax-free growth. There are no income limits for a Roth conversion and, while they and other distributions may trigger a taxable event, our doctors can mitigate their tax bills from this conversion (as well as other taxable distributions) by pairing tax strategies. For instance, a client could make an interest payment on their reverse mortgage to off-set tax obligations from a withdrawal or roth conversion, further expanding accessible equity in the process. In this way, the tax obligations of a mandatory Required Minimum Distribution (RMD) or desired but consequential Roth conversion can now be paired with the reverse mortgage's interest payment to solve for these tax liabilities and further increase available sources of tax-free capital.

In summary, a reverse mortgage can provide the following strategic benefits:

- Eliminate future mortgage payments (must still pay property taxes, insurance, and maintain the home).
- Portfolio preservation (delay / avoid investment account withdrawals)
- Access as a line of credit during market downturns
- Pay for Long-Term care and/or other health care expenses.
- Fund a variety of other structures to ensure generational wealth.

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Physicians Financial Services is an independent financial services firm specializing in the unique financial needs of doctors and their families, as well as other productive individuals. A national practice, PFS has administrative offices in Omaha, Nebraska.

Contact us today to get started, and we'll help you come up with strategies that are right for your needs. Ask us about our four-question "Loss Test" to help us determine if we can help you.

Schedule a Consultation **Schedule a Client Review**

Like-Kind Real Estate

To complete a successful Section 1031 tax-deferred exchange, a replacement property must be like-kind to the relinquished property. Some examples of like-kind properties include:

- Multifamily Apartments
- Healthcare
- Self-Storage Facilities
- Retail Centers
- Industrial Warehouses
- Student Housing
- Senior Living
- Hospitality

Any real estate held for productive use in a trade or business or for investment purposes is considered like-kind. A primary residence would not fall into this category, however, vacation homes or rental properties may qualify.

Accredited Investor Requirement for DSTs

Delaware Statutory Trusts (DSTs) are available to accredited investors only. The regulation of accredited investors is put forth by SEC in Rule 501of Regulation D.

To be an accredited investor, a person must have an annual income exceeding $200,000 ($300,000 for joint income) for the last two years with the expectation of earning the same or a higher income in the current year. An individual must have earned income above the thresholds either alone or with a spouse over the last two years. The income test cannot be satisfied by showing one year of an individual's income and the next two years of joint income with a spouse.

A person is also considered an accredited investor if they have a net worth exceeding $1 million, either individually or jointly with their spouse. The SEC also considers a person to be an accredited investor if they are a general partner, executive officer, or director for the company that is issuing the unregistered securities.

Important Risk Factors to Consider

DSTs involve certain risks including but not limited to tax risks, general real estate risks, risks relating to the financing on the applicable property, if any, risks relating to the ownership and management of the property, risks relating to private offerings and the lack of liquidity, and risks relating to the Delaware statutory trust structure. In addition, sponsoring organizations can give no assurance that it will be able to pay or maintain distributions, or that distributions will increase over time.

An investment in an DST-sponsored program is subject to various risks, including but not limited to:

- No public market currently exists, and one may never exist, for the interests of any DST-sponsored program. The purchase of interests
- in any DST-sponsored program is speculative and is suitable only for persons who have no need for liquidity in their investment and who can afford to lose their entire investment.
- DST-sponsored programs offer and sell interests pursuant to exemptions from the registration provisions of federal and state law and, accordingly, those interests are subject to restrictions on transfer.
- There is no guarantee that the investment objectives of any particular DST-sponsored program will be achieved.
- The actual amount and timing of distributions paid by DST-sponsored programs is not guaranteed and may vary. There is no guarantee that investors will receive distributions or a return of their capital.
- Investments in real estate are subject to varying degrees of risk, including, among other things, local conditions such as an oversupply of space or reduced demand for properties, an inability to collect rent, vacancies, inflation and other increases in operating costs, adverse changes in laws and regulations applicable to owners of real estate and changing market demographics.
- DST-sponsored programs depend on tenants for their revenue, and may suffer adverse consequences as a result of any financial difficulties, bankruptcy or insolvency of their tenants.
- DST-sponsored programs may own single-tenant properties, which may be difficult to re-lease upon tenant defaults or early lease terminations.
- The long-term impact of the COVID-19 pandemic and the resulting global financial, economic and social distress remains uncertain.
- The prior performance of other programs sponsored by DSTS should not be used to predict the results of future programs.

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- The acquisition of interests in an DST-sponsored program may not qualify under Section 1031 of the Internal Revenue Code of 1986, as amended (the "Code") for tax-deferred exchange treatment.
- Certain of the programs previously sponsored by DSTS have experienced adverse developments in the past.

Restrictions and Required Approvals for Reverse Mortgages

Most but not all reverse mortgages are Home Equity Conversion Mortgages (HECMs) and are only available through an FHA-approved lender. Reverse mortgage borrowers are required to obtain an eligibility certificate by receiving counseling sessions with a HUD-approved agency. The youngest borrower must be at least 62 years old. Monthly reverse mortgage advances may affect eligibility for some other programs. Not all prospective customers will qualify. Information, rates and programs are subject to change without notice. All products are subject to credit and property approval. Other restrictions and limitations may apply.

Disclaimer

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