# Appreciated Real Estate

## A Sterling Advisor Guide

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**Executive Summary**

Long term owners of real estate often have large taxable gains, the result of increases in market value, depreciation, or both. Income properties that have been held for the long term will usually have taxable gain resulting from depreciation, even if the market value has not risen. Two common motives for selling such appreciated real estate are the desire to diversify what has become a concentrated position, and the desire to free oneself of the management hassles that often accompany real estate. The desire to avoid capital gains tax is a major reason owners hesitate to sell. This chapter explores the four most common solutions to the situation.

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# Case Study

Harry Lyons has been in the apartment business for most of his 71 years. Harry loves real estate, and made a great deal of money in real estate. But with the birth of his first grandchild, Harry began to think about slowing down. He wanted to spend more time with his wife, and their daughter and grandchild. Harry found that he was getting less joy and more hassle from owning apartments. Harry toyed with the idea of selling, or maybe of doing a tax-free exchange into lower-hassle triple-net lease property. But it was the government's response to COVID that drove Harry to action.

The anti-landlord rules imposed by Congress in the spring of 2020, and extended by the CDC were, in Harry's words, "The kick in the butt I needed." After getting over his anger and incredulity, Harry determined to act. ("How in the hell does the CDC have the right to tell my tenants they don't have to pay rent?" Harry thundered when he heard that this once obscure "unelected government agency was digging in my pockets.")

Harry was thinking again about a tax-free exchange, and brought it up with his advisor. The advisor wanted to examine all the alternatives, and called us to do discuss.

*Process*

We began by sitting down with the advisor and Harry to discuss Harry's goals. For Harry, his main goal was to get rid of the real estate risk, diversify his holdings, and spend less time worrying about his business or his investments. He would then have a more peaceful life, and more time to spend with his family and friends.

Though we often spend some time examining the portfolio risks of concentrated real estate holdings, Harry's experience with not receiving rent from many of his tenants, and not being able to evict them, made that a discussion mainly involving Harry venting. "Excess risk!" he fumed. "That's one thing to call it. I call it theft!"

*Taxes*

As with many property owners, Harry's real estate had appreciated a great deal, and his tax basis, after depreciation, was functionally zero. Harry owned a number of buildings in and around Phoenix. When he bought them in the early 1990s, his average cap rate[1] was, he recalls, "a bit over 7, which was pretty good." Between increases in rent the rolls, some improvements Harry had made over the years, and the drop in cap rates, Harry's properties would fetch about $15 million, which would be essentially all taxable because of depreciation. In addition, because he'd taken about $4.6 million of depreciation over the

1 In real estate, *cap rate* is short for *capitalization rate*. It refers to the yield that would be earned by an owner who bought the property for all-cash. It is essentially net operating income divided by asset value. It is analogous to a bond yield.

years, he'd have to pay a higher tax rate on his "recapture." The one thing Harry felt was in his favor was the recent Arizona Supreme Court ruling overturning the state's 2020 state tax hike.

Still, between capital gains taxes, recapture, and state income tax, if Harry sold his properties, he'd be looking at a tax bill in the neighborhood of $4.5 million. "I'd rather die!" he said, than pay that tax.

*Alternatives*

His advisor explained that if Harry held the properties until he did die, the properties would then get a "stepped up basis" and Harry wouldn't have to pay tax. Harry said he knew that, but as he figures to live for many more years, that's not a solution.

They considered a 1031 exchange (explained below), and an installment sale (explained below), and finally decided that the best solution for Harry was a §664 Real Estate Shelter Trust (explained below).

*Solution*

We explained to Harry that he could create a tax-exempt trust that would provide income to him and his wife for as long as they lived, and then to each of his two children for as long as they lived. In the actual detail, that required two trusts, but from Harry's point of view, it was seamless because we and the advisor did all the work.

We created the two trusts, and worked with Harry's legal advisor and real estate broker to create Lyons Roar LLC to hold all his properties. Harry used the Lyons Roar interests to fund the trust before starting the sale process. Lyons Roar then engaged the broker, who listed the properties. When the dust settled, Lyons Roar ended up with just over $15,120,00, which the advisor is investing in a diversified portfolio.

*Outcome*

Harry and his wife are eligible to take income up to about $756,000 per year, and that number will grow as the trust grows. But because of the way the trust is set up, Harry's advisor has the ability to defer the payments, and also defer the tax that Harry would owe. The unpaid amounts will build up in the trust, for Harry, or his family's, later use.

# Section 1: Excess Risk in Concentrated Real Estate Holdings

It has been known since ancient times that investing is risky, and that one good way to manage risk is to hold a diversified portfolio. The idea that risk can be reduced through diversification has been studied extensively since the 1950s.

Modern Portfolio Theory begins with the work of Harry Markowitz, a University of Chicago economist who was awarded the Nobel Prize in 1990.

Markowitz described a mathematical procedure for determining how to construct a portfolio of investments that would have the minimum theoretical risk, while still offering the same amount of expected return. His work is still referred to as the Markowitz Model.[2]

Markowitz, and many who have come after him, have proven mathematically that, unless we know the future, everything else equal, intelligent diversification will reduce the risk in a portfolio, without reducing the expected return.

Markowitz, and most financial economists, have focused most of their research on stock and bond investing. The main reason they have done so is the fact that stocks and bonds trade daily on exchanges, and the data is publicly available, while most real estate properties trade at most once every few years, and the transaction details are necessarily easily available.

*Risk in Real Estate*

From the point of view of Modern Portfolio Theory, real estate is just another assets like stocks, bonds, and cash. That is, theoretically, real estate can be a useful holding in a portfolio, and can be analyzed the same way any other holding would be treated.

Perhaps the biggest issue in analyzing real estate is the fact that most real estate (except REITs and a few real estate companies) is not traded on a public market. Whereas most decently sized corporations have stock that is publicly traded, few real estate properties do.

*Public vs. Private Real Estate*

In one sense, the main difference between publicly traded real estate, such as REITs, and non-publicly-traded real estate, such as most buildings, is liquidity.

Liquidity is a measure of how long it takes to sell an asset for cash, and how much it costs in transactions costs. Actively traded stocks are very liquid. For example, you could sell

2 Markowitz made a number of assumptions about the expected return, standard deviations, and co-variances among returns of a universe of assets. Given these assumptions, he then provided a method, called quadratic optimization, to find the portfolio with the lowest risk (variance) for a given level of expected return. For a fuller discussion of Modern Portfolio Theory, ask your advisor, or contact Sterling Foundation Management, for a copy of the chapter Basic Portfolio Theory from our forthcoming book, *The Intelligent Layman's Guide to Personal Investing.*

five million dollars worth of Microsoft stock almost immediately (during market hours), make little or no difference to the market price, and pay little or no commission (depending on your broker).

Privately held real estate is another matter. Apartment buildings are generally the most liquid type of investment real estate. But liquidity here is measured in weeks or months to sell, and commissions, depending on many factors, may range from 3% to 6%.

### Risk in Private vs. Public Real Estate

Consider two similar apartment complexes. They're in the same area, they have roughly the same type of units, the same type of amenities (e.g. pools, common areas), the same access to the road network, were built at the same time, maintained the same, even managed by the same company. Now consider that one of them is owned by a REIT that trades publicly, while the other is owned privately.

You might think that from the point of view of risk, it doesn't make much difference which property you own. They are both going to be affected by the same economics, by the same factors of supply and demand. Short of something like a fire, it's pretty hard to come up with a scenario where one complex prospers and the other suffers. In other works, the economic risks to the two complexes are pretty much the same.

And yet, many people in the investment world insist that the privately held, non-publicly-traded real estate is much, much safer. That seems absurd! But we didn't make this up. Here's evidence from a Morgan Stanley publication[3]:

Display 2: **Risk-Return Time Series**

| ASSET CLASS | 10-YEAR TOTAL RETURN | 10-YEAR STD. DEVIATION |
|---|---|---|
| Real Estate (Private) | 8.4 | 6.3 |
| Real Estate (Public) | 9.5 | 25.8 |

This and similar claims are often repeated. But to us, it makes no sense to believe that there can be such a huge difference in risk simply because some real estate is owned by publicly traded entities, and some is not. So what is going on?

That brings us back to Harry Markowitz, and the mathematics of risk. Markowitz, and the entire field of academic finance, defines the risk of an asset as the standard deviation of return on that asset, or some similar statistical definition.

Standard deviation of return makes sense when you have lots of data. Stocks and bonds, which trade every day, provide roughly 252 daily returns each year. That's plenty of data on which to perform meaningful statistics. For example, if we look at the calendar year 2021, the return on Microsoft stock had an average daily standard deviation of 1.32%. Using a bit of math, we can estimate that equates to an annual standard deviation of 21%.

If we look at publicly traded REITs, we find somewhat similar patterns. The daily returns on publicly traded REITs show volatilities that equate to annual standard deviations that

3 *Views From The Observatory: Real Estate Portfolio Risk Management And Monitoring*, 2015

range from the low 20s to high 30s percents. This is not surprising, and is roughly in line with the volatilities of similar non-real estate stocks.

### Private Real Estate – Less Risky?

So where in the world does the claim that privately owned, non-traded real estate is vastly less risky come from? How can a firm like Morgan Stanley repeat this seemingly absurd claim?

The claim originates from data compiled and published by the National Council of Real Estate Investment Fiduciaries (NCREIF). NCREIF is heavily influenced by institutional managers of investment real estate.

The NCREIF data show that returns to privately owned real estate are much, much smoother – that is they are less volatile – than returns to publicly traded REITs. The data do in fact show that. The question is: why?

Either it is really true that privately held, non-publicly traded real estate really is less volatile, or the difference is only apparent and is a function of the data and/or the way the data is analyzed.

We believe the answer is simple. In the words of real estate expert Peter Linneman[4], "The data are wrong."[5] Linneman's paper, cited in the footnote, is 13 pages, and we invite you to read it if you want detail on why he concluded that the data are wrong.

4 Linneman is the author of *Real Estate Finance and Investments: Risks and Opportunities*, Linneman Associates, 2004.
5 Peter Linneman, *The Return Volatility of Publicly and Privately Owned Real Estate*, Wharton Working Paper #493, Review

### Concentrated Holding Risk

A careful consideration of the theory and evidence strongly suggests that owning individual properties is about as risky as owning individual stocks. Some are riskier than others, but as with stocks, owning a concentrated real estate holding exposes the owner to excess risk.

For an in-depth discussion of concentrated risk, please see our *Sterling Advisor Guide: Concentrated Stock Positions*.

With a concentrated stock position, the desire to avoid tax is a major reason that causes owners to hesitate to sell and diversify their concentrated stock position.

With real estate, taxes are often an even greater barrier to selling and diversifying.

# Section 2: Real Estate Gains and Tax

### The Two Sources of Taxable Gains on Real Estate

In the United States, owners of real estate who sell may be subject to tax on the gains realized on sale[6]. There are two major sources of taxable "gains" on the sale of real estate. These are increases in the market price of the property between the time you bought it and the time you sell it, and the gain that results from depreciation and so-called recapture.

*Two Kinds of Increase in Market Price*

An increase in the market price of your real estate is the most obvious source of a gain. If we ignore inflation, an increase in the price of a piece of property represents a real gain for the owner. For example, suppose you purchased a property for $1 million, and sell it ten years later for $2.2 million. You will have realized a gain of $1.2 million.

In the US, as this is written, the top federal tax rate on capital gains is 23.8%.[7] In addition, the average state tax rate is about 6.2%, making the average effective top rate on capital gains about 30%. In some states like California and New York, that effective top rate can be 38% or more.

If the tax on the sale of real estate were a straightforward capital gains tax at 30%, the gain on the above $2.2 million sale would be 30% of $1.2 million, or $360,000.

But in reality, that $1.2 million gain was not all "real" because the dollar lost a significant amount of its value in the ten years that the property was held. For example,[8] based on official statistics, in the ten years ending in 2022, the dollar lost over 22% of its value. In that time, the Consumer Price Index increased from about 229 to about 292.

Based on this measurement of inflation, what $1 million would buy in 2012 would require $1,275,000 to buy in 2022.

*Inflation*

Because of inflation, even if the $1 million property purchased in 2012 didn't go up at all in real terms, its market price would have had to increase by $275,000 just to keep the owner even. But the US government taxes that $275,000[9] anyway. This is merely one of many examples of how inflation is a hidden

6 Not all countries tax capital gains. For example, Singapore, the 4th wealthiest country in the world by per-capitaa GDP, has no capital gains tax. A number of other extremely wealthy countries, including Belgium and Switzerland, also generally don't tax capital gains.

7 You will often read that the top capital gains tax rate is 20%. That is at best a half-truth. The government imposes an additional 3.8% tax (enacted ostensibly to pay for socialized medicine under Obama, but in fact it just goes into the giant maw of government like other taxes) on most income above certain thresholds.

8 Consumer Price Index as reported by the Minneapolis Fed, including an estimate for 2022.

9 Here's the math: We divide the 2022 CPI by the 2012 CPI, to get 1.275. We then multiply the $1 million in 2012 by 1.275 to arrive at the "equal purchasing power" number of dollars in 2022.

tax.[10]

## Depreciation

Investment property in the US is subject to depreciation for tax purposes. Depreciation is both an economic concept and an accounting concept.

*Economic Depreciation*

Most types of physical capital assets deteriorate with time and usage. We all experience this in our daily lives. Cars go from being new and in perfect working order, to eventually end up in the service bay, or the junkyard. Household appliances break down, and must be repaired or replaced. Electronics not only break down, but they may become obsolete even while they still work technically. Even houses and buildings must be maintained, and if we don't spend money keeping the up, they will deteriorate, and eventually fall down.

This phenomenon of physical assets losing economic value over time is called depreciation.

Somewhat confusingly, the same term is applied to the way that accountants account for the cost of a capital asset.

*Accounting Depreciation*

When a business purchases an asset that the business expects to use for more than one year, the business must decide how much of the purchase price to allocate to expense each year. For example, if an airline buys a 787 jetliner for $285 million, the airline's accountants will not consider all of that $285 million an expense in the year of purchase. That's because the airline expects to operate the plane, probably for decades.[11]

But just how much of the $285 million can be expensed each year? That's where accounting depreciation comes in. For example, an airline's accountants might determine that the airplane will have a twenty year life, and at the end of the twentieth year it will be sold for $35 million. That would mean that the airplane will depreciate by $250 million over twenty years. If the airline chooses "straight-line" depreciation, it will record a depreciation expense of one-twentieth of $250 million, or $12,500,000, each year.

*Tax Depreciation*

Depreciation is a non-cash expense, but depreciation is deductible from income for purposes of calculating federal income taxes. Businesses wishing to minimize their income taxes will therefore seek to take the maximum depreciation expenses allowed. The tax law on depreciation is somewhat complicated. And from here on we will discuss only real estate depreciation.

*Real Estate Depreciation Tax Laws*

Most real estate consists of land plus buildings. Land is not depreciable for tax purposes. Buildings are. As a general rule, residential buildings must be depreciated using the straight line method over a life of 27.5 years, and commercial buildings over a period of 39 years.

10 Ask your advisor, or contact Sterling Foundation Management, for a copy of our book on inflation titled *Politicians Spend, We Pay*.

11 Boeing, which manufactures the 787, estimates that a typical plane will have a useful life of about 30 years, or 44,000 pressurization cycles.

However, it can get much more complicated than that. Most buildings contain some systems, such as HVAC systems, some electronic systems, and elevators, that have useful lives much shorter than the standard 27.5 years or 39 years. Depending on the size and complexity of the real estate business, these shorter-lived assets may be depreciated on a different schedule. Chances are, if you're a real estate investor, you are an accountant, or you retain the services of an accountant.

Depreciation expense reduces ordinary taxable income in the year that the depreciation is expensed. Unfortunately, when a property is sole in a taxable environment, the depreciation is "recaptured" and taxed at a rate higher than the capital gains tax rate. Recapture of real property (i.e. building) depreciation is taxed at 25% plus often the 3.8% surtax, while depreciation recapture on other types of property can be taxed at ordinary income tax rates.

*Example*

Consider an apartment building that was purchased for $3 million. Assume that $250,000 of the purchase price was allocated to the land, leaving $2,750,000 in depreciable property. Annual depreciation will be $100,000. After ten years, the property owner's basis (i.e. the number used for computing the gain on sale) will be $2 million. It is $2 million because the original basis was the purchase price of $3 million, less ten years of depreciation (which reduces cost basis) at $100,000 a year.

For an owner in the top tax brackets, if the building is now sold in year 10 for $3 million, even though the owner has no gain (even ignoring inflation), the owner will recapture the $1 million of depreciation, and have to pay tax on that, at a rate of 28.8%. This assumes that all the depreciation was taken on real property, i.e. §1250 property. The tax bill would be $288,000.

It could be even worse. Suppose that the building owner had elected to use a technique called cost segregation, in which certain assets (e.g. HVAC) can be depreciated faster. If $100,000 of the depreciation taken had been this type (§ 1245) of property, that $100,000 will be taxed at 40.8%. The total tax on the sale will now be $300,000.

# Section 3: Four Established Methods of Selling Appreciated Real Property

There are four methods through which an owner can dispose of appreciated real property. They are:

1. An outright sale
2. A 1031 exchange
3. An installment sale
4. A Real Estate Shelter Trust

## 3.1 Hedging

With an appreciated concentrated stock holding, it may be possible, for limited periods of time, to limited the excess risk of the concentrated position by hedging.

To over-simplify, hedging is the purchase of a position that goes up in value when what you own goes down in value. Please see *Sterling Advisor Guide: Concentrated Stock Positions*. for more details.

When it comes to real estate holdings, there is in most cases, no reasonable way to hedge. Theoretically possible ways include shorting individual REIT stocks, purchasing puts on individual REIT stocks, or shorting or buying puts on a REIT or real estate index.

There are at least persuasive reasons that such hedges would rarely, if ever, be a good idea. These reasons are cost, complexity, and basis risk.

Of those three terms, you are no doubt familiar with the cost and complexity. Because REITs tend to be relatively high dividend payers, it is relatively costly to short them. When you short a stock, and the stock pays a dividend, you must send the money to pay the dividend or the broker will take it directly out of your account. Buying puts will not avoid this cost, though it is harder to see and harder to explain.

Even if you could get past the cost and complexity, which if you are willing to put in the time, and/or you retain the advice of a competent professional, you can, you will likely be stymied by basis risk.

Basis risk is the risk that the price of your hedge does not move in perfect lockstep with the price of what you are trying to hedge. In a classic hedge, such as using gold futures to hedge a holding of gold bars, the basis risk is very low,[12] because to a very high degree of correlation, when spot gold prices rise, futures rise by a predictable amount, and when spot gold prices fall, gold futures prices fall by a predictable amount. The correlation between spot gold prices and gold futures prices is very close to one.

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12 It is not, however, zero. The main source of basis risk between spot gold and gold futures is interest rate risk. The role of interest rates in the arbitrage between spot gold and gold futures is so great (interest rates account for substantially all of the difference between gold spot and futures prices almost all the time) that in the days before the development of interest rate futures contracts, some sophisticated traders used the spreads between gold contracts to trade interest rate futures.

However, in most cases there is little reason to believe that any publicly traded security, futures contract, or option contract would move in price with a high correlation with the price of a non-traded, privately owned real estate holding.

If you can't hedge or decide that hedging doesn't solve the problem of excess risk, there are four alternative strategies to consider. Discussion follows.

## 3.2 Outright Sale

The simplest and most obvious way to reduce the risk of holding a concentrated position in real estate is to sell the property for cash. The downside is that if there is a gain, that gain will be subject to capital gains tax, and possibly some amount of depreciation recapture that may be taxed at higher rates. Taxes are the main reason owners consider other alternatives.

*A Note on Seller Financing*

Sometimes a seller of a property will be asked to provide "seller financing" or some similar term. Seller financing may occur when a buyer is offering the seller a price that is acceptable to the seller, but the buyer does not have and cannot borrow from a regular mortgage lender the full amount of the purchase price.

In this case, which was common in the days of high interest rates but much less common in recent years, the seller receives the sale proceeds in the form of part cash, and part a mortgage on the property.

The analysis of the value of such a retained mortgage is beyond the scope of the present discussion. However, it is almost axiomatic that the true market value of such a seller-retained mortgage is less than the face value. Seller financing should be considered only after a thorough examination of the alternatives, and the true fair market value of the seller-retained mortgage, has been completed.

Particularly in times of rising interest rates, seller-retained financing can turn around and bite the seller.

## 3.3 1031 Exchange

Most people involved in real estate investing have probably heard about, or done, a so-called "1031 exchange." The phrase 1031 exchange refers to a properly structured exchange of real estate for other "like-kind" real estate. A properly structured like-kind exchange does not generate income tax for the "seller."

The "1031" refers to section 1031 of the Internal Revenue Code. That means it's an income tax issue, and if you are considering a 1031 exchange you should get competent professional advice. To a first approximation, all domestic (in the US) real estate is "like kind" to other domestic real estate. However, both the old and the new properties must be held by the "seller" for investment or use in a trade or business. That means, again as a first approximation, that a primary residence is not eligible for 1031 exchange.

Being a creature of the tax law, and having developed over the past century, the law of 1031 exchanges is extensive, and the above just barely scratches the surface. If you are considering a 1031 exchange, unless you are an expert yourself, you need expert advice.

*When A 1031 Works Best*

There are many potential “gotchas” in a 1031 exchange. For example, if you get cash out, it will be taxable. If you reduce the amount of debt, it will be taxable. If you don’t get it completed in the allowed amount of time, the entire sale may be taxable. If you don’t “dot the i’s and cross the t’s” you may end up with an unwelcome tax surprise.

However, if you do it right, and are willing to get no cash out of the deal, keep at least as much debt, and own at least as much property (by value) as before, a 1031 might work.

There are undoubtedly many valid investment reasons for a real estate owner to use section 1031 to exchange one property for another. But owners using 1031 to reduce the risk or hassle of property ownership will often be disappointed.

*1031 Exchange to Avoid*

*Management Responsibility*

When a property owner wants to shed his or her management responsibilities, and the risks and headaches that go along with such responsibilities, a broker will sometimes recommend a 1031 exchange for a triple-net-leased property. Such leases are sometimes call NNN leases.

The primary attraction of a triple net lease is that it requires very little involvement from the property owner. From an economic point of view, at least as long as the lease is working the way the property owner expects it to, owning a triple net lease is like owning a bond.

Unfortunately, it is exactly those bond-like characteristics of a triple net lease that make triple-net leases risky.

*Triple Net Lease Credit Risk*

Triple net leases often represent a concentrated credit risk to the property owner. A typical property owner using 1031 to exchange from a management intensive type of property – such as apartments, commercial or retail – will exchange the old property for the triple net lease of a single tenant.

For example, consider a representative situation. An apartment owner had owned apartments in Southern California for decades. As she approached retirement age, and none of her children were interested in managing the apartments, she decided to exchange the apartments, then worth $3,500,000, for a retail property in Arizona that was triple-net leased to a national restaurant chain location.

The property owner used the appropriate 1031 expertise, and the apartments were exchanged for the triple-net-leased center. (Not directly. All or almost all exchanges use a specialist middleman, so if you own apartments, you don’t have to find the needle-in-a-haystack who wants your apartments and whose triple-net-leased property you want.)

For a while, everything went smoothly. Then the economy slowed, and the restaurant business slowed down. The restaurant decided to see what would happen if they didn’t pay their lease.

That put the property owner in a tough position. A restaurant is a single-use property. If the property owner evicted the restaurant, she'd have to find another one to go into the space. There would be expenses involved, as even if the kitchen could be kept the same, most chains have a certain look and style. Maybe she could convince a new tenant to pay for the changes.

But in the meantime, the property would be vacant for at least the time it took to get the old tenant out and the new one in. And during that time, not only would the property owner not receive her lease payments, but all the expenses that were supposed to have been paid by the lessee, including the property taxes, the maintenance, and the insurance. Ouch! Once she got over her dismay, this property owner started referring to the NNN concept as "triple nuts!"

*Bond Diversification*

Professional bond investors know that it is extremely difficult to predict, over the long term, which companies will remain credit-worthy. As a consequence, even though they employ large staffs of credit analysts, most professional bond managers will spread their bond investments over a very large number of bond issuers. That way, even if some of the bond issuers default, the overall portfolio will not be hit too hard. For example, as of April, 2022, the Vanguard Intermediate Term Corporate Bond Fund held 2214 different bonds! That's diversification.

Sometimes, the credit of the tenant is excellent. But even when that credit is excellent, things can and sometimes do change. For example, in 2000, Sears had a credit rating of A-. It had been in business, often in the same locations, since before WWII or longer. By 2018, it was bankrupt.

Most triple-net leases that are available for 1031 exchanges for non-institutional size investors (less than about $50 million) are available on retail properties. And retail properties are heavily tenanted by, not surprisingly, retail stores and outlets. And that means risk that might not be obvious. For example, in 2020 alone, here is a partial list of chain restaurants that went bankrupt:

- Souplantation.
- Friendly's.
- Ruby Tuesday.
- Sizzler.
- Chuck E. Cheese.
- California Pizza Kitchen.
- Le Pain Quotidien.
- Wendy's and Pizza Hut operator, NPC International.
- IHOP

And here is a list of retail bankruptcies from 2020

- J. C. Penny
- Neiman Marcus
- Guitar Center
- Tailored Brands (Men's Wearhouse)
- Ascena Retail (Ann Taylor & Loft)
- GNC
- J. Crew Group
- Brooks Brothers
- Stein Mart
- Pier 1 Imports

*Selective Lease Rejection*

Too many property owners who exchange for a triple net lease learn the hard way about something called selective lease rejection.

The US Bankruptcy Code, § 502(b)(6), in effect allows a bankrupt company to selectively reject leases. By selectively, we mean that it can reject some leases, while keeping others. In general, the landlord owning a property on which a bankrupt tenant has rejected the lease has limited recourse. The landlord's damages are capped by the law, and the landlord generally becomes an unsecured creditor, which is not a favorable position.

Selective lease rejection means that a large tenant can ignore the terms of its leases and keep the leases it likes and reject, or break, the ones it doesn't. From the point of view of the landlord leasing to such a tenant, the existence of the right of select lease rejection is equivalent to the landlord giving an option to the tenant. As far as we can tell, triple net lease rates do not in general adequately compensate the property owner for the value of that option that is, by law, given to the tenant.

*Lease Terms*

A triple-net-lease lease agreement is likely to be a complex legal document, with a number of clauses and sub-clauses the importance of which might not be obvious to an investor with no previous experience in triple-net-leases. Unlike a typical residential or commercial lease, which is usually drafted by the landlord (or a group representing landlords) a triple-net-lease is likely to have been drafted by the tenant, or a group representing tenants. Prospective investors in a triple-net-leased property who are not themselves experts, should obtain expert advice.

*Interest Rate Risk*

As if credit risk weren't enough, a triple net lease often comes with a lot of interest rate risk. This risk may not be immediately apparent, because it may be presented as a benefit. Who wants to have to re-lease a property every year or two? Not most owners who are trying to avoid the hassles of real estate ownership.

Thus, when a lease with a name tenant is for twenty years, that might be seen as an advantage by both the broker and the property owner. And ignoring credit risk, it might be. But because a triple net lease is essentially a stream of fixed payments, the math of bonds means that a twenty year triple net lease has almost as much interest rate risk as a bond of similar term.

That's a lot of interest rate risk.

*Real Estate Valuation Risk*

Until recently, few people would have worried that over the long term, high quality retail investment property would permanently lose value. In fact, that was one of the core beliefs of billionaire investor Edward Lampert when he bought Sears. Unfortunately, Lampert was wrong. His misplaced confidence in the value of Sears' real estate cost him an estimated 2/3 of his fortune between 2012 and 2019.[13]

When you own a property that is triple net leased, you still bear all the market risk of

13 Per Forbes, https://www.forbes.com/profile/edward-lampert/?sh=1863c691546d

the real estate itself. That includes the risks associated with local market conditions, with the shifting habits of the public that uses the real estate, with the possibility of technological obsolescence (e.g. parking lots that must be retooled for electric cars, or buildings that no longer have the wiring required by new tenants), as well as the huge macro risks of shifts like the shift from brick-and-mortar stores to online stores.

If you have a significant holding in real estate, you are probably an expert on the local market for that kind of real estate. But you may have significantly less expertise on the local market and type of real estate that you receive if you exchange for a triple-net leased property. *Caveat Emptor.*[14]

An alternative to a 1031 exchange to a triple-net-leased property could be an installment sale.

## 3.4 Installment Sale

An installment sale is a sale of property for a combination of cash and a note that qualifies for installment sale treatment under section 453 of the internal revenue code.

Under a qualified installment sale, the seller receives taxable capital gains, along with interest income which is taxed at ordinary income rates, over a series of payments. These payments are called installments, and therefore the transaction is called an installment sale.

*Benefits of Installment Sale*

The main benefit of selling a property via an installment sale is the spread of the realization, for tax purposes, of the gain over a number of years. If the gain is relatively small, and the seller is in low enough tax brackets, an installment sale can be an effective way to lower the overall tax enough to make it worthwhile.

Consider an example of a seller who has a property with $1 million in gain. For simplicity, we will ignore depreciation recapture. We assume that the seller is married, and has income of $200,000 from non-property sources. Again, for simplicity we assume that the seller lives in a zero income tax state.

If the seller sells the property outright, the seller will have $1,200,000 of taxable income. The seller will incur capital gains tax at the maximum rate of 23.8%, resulting in a capital gains tax on the $1 million gain of just under $240,000.

If instead the seller spread the $1 million gain over four years via an installment sale, and ignoring the fact that doing so will, in effect, convert some of the capital gain into ordinary income, the tax on the $1 million will be about $47,000 a year for four years, for a total of $188,000. The tax saving would be about $50,000.

14 *Caveat Emptor* (“let the buyer beware”) is not only a proverb. It is an historical legal principle, with particular application to real estate. Cornell’s Legal Information Institute defines it as, “A doctrine that often places on buyers the burden to reasonably examine property before purchase and take responsibility for its condition.” We expand that to the prudent investor to also understand the market conditions, and the various risks we outline.

*Drawbacks of Installment Sale*

The above example over-estimates the tax savings, because to qualify note (the unpaid portion of the sale) will have to bear interest. Everything else equal, that interest will be taxed at a rate that, as of this writing, is about 40.8% federal, as compared to 23.8% for capital gains. The rate of interest varies with time.

In addition, the seller who accepts an installment note becomes a creditor of the buyer. If the buyer is unable, or unwilling for whatever reason, to make the payments on the installment note, the seller could have expenses and costs to recover the amounts due.

A third potential drawback of an installment sale is precisely the fact that the sale is not for cash. The seller can reinvest only the proceeds, after tax, as the proceeds are received. If an installment sale is over four years, you won't have the full proceeds, even if things go according to plan, until the fourth year.

A fourth potential drawback of an installment sale is the risk that tax rates could be higher in the future years. If you sell a property on an installment basis, you are taxed on the income in the year that you receive it, at whatever tax rates are in effect in that year.

*Depreciation Recapture*

We mentioned recapture earlier. If you have depreciated a property, and you sell the property via an installment sale, you may be taxed on the depreciation recapture in the year of the sale, regardless of the length of the installment sale and regardless of when you actually get the money.

*Mortgages, Contract Price, and Gross Profit Percent*

The actual working of an installment sale is a bit more complicated than the example above of the four year sale. The actual calculations require the computation of the taxable profit, the contract price, the treatment of any mortgages on the property, and the calculation and application of a factor called the gross profit percentage.

Here are some simple formulas that are useful in calculating actual taxable amounts under an installment sale.

| Value | How To Calculate |
|---|---|
| Selling Price | Cash Received<br>+ Debt Paid (Or assumed by buyer, including mortgages)<br>+ Fair market of property received (if any) + Selling Expenses (paid by the buyer) |
| Total Gain | Selling Price<br>– Selling Expenses<br>– Adjusted Basis of Property |
| Contract Price | Selling Price<br>– Liabilities Assumed by Buyer<br>+ Amount by which liabilities assumed by buyer exceed adjusted basis |
| Installment Sale Basis | Adjusted Basis<br>+ Selling Expenses<br>+ Recaptured Depreciation |
| Gross Profit | Selling Price<br>- Installment Sale Basis |
| Taxable Annual Gain | Total Gain<br>÷ Contract Price |

*Example*

Suppose that in January of 2022, an investor named Rick owns an office building, which he sells to Andrew for $1.5 million. Andrew assumes a mortgage debt of $200,000. He also makes a $400,000 down payment and gives Rick a $900,000 promissory note, providing for the appropriate interest. Sale expenses are $30,000. Rick's adjusted basis in the property is $300,000. (Assume that there is no recapture income). After the sale but before the closing of Rick's taxable year, Andrew gives an installment payment to Rick worth $200,000. Rick's taxable gain in the year of the sale is calculated as follows:

*Step 1: Gross Profit*

| | |
|---|---|
| Selling Price | $1,500,000.00 |
| Adjusted Basis | -$300,000.00 |
| Selling Expenses | -$30,000.00 |
| **Gross Profit** | **$1,170,000.00** |

*Step 2: Contract Price*

| | |
|---|---|
| Selling Price | $1,500,00.00 |
| Debt Assumed | -$200,000.00 |
| **Contract Price** | **$1,300,000.00** |

*Step 3: Gross Profit Percentage*

| | |
|---|---|
| Gross Profit | $1,170,000.00 |
| Contract Price | $1,300,000.00 |
| **Gross Profit Percentage (GP/ CP)** | **90%** |

*Step 4: Payments Recieved Through the Taxable Year*

| | |
|---|---|
| Down Payment | $400,000.00 |
| Installment Payment(s) | $200,000.00 |
| **Payments Through Year** | **$600,000.00** |

*Step 5: Gain Recognized in Sale Year*

| | |
|---|---|
| Gross Profit Percentage | 90% |
| Payments Through Year | $600,000.00 |
| **Gain Recognized (GP% * Payments)** | **$540,000.00** |

*Step 6: Additional Income Recapture*

| | |
|---|---|
| Recapture Income | $0.00 |
| **Total Income for 2022** | **$540,000.00** |

As you can see, the use of the installment method allows Rick to pay less taxes; while he earned a profit of roughly $1.2 million, he only has to report $540,000 as taxable gain in the year of the sale.

## 3.5 Real Estate Shelter Trust

A real estate shelter trust is a tax-exempt trust. Contributions of appreciated real estate to such a trust are tax-free, and the trust can then sell the real estate, immediately, with no tax due. The trust then can reinvest the entire proceeds into a diversified portfolio. Furthermore, as long as the assets remain in the trust, there is no tax on income or capital gains realized by the trust. In addition, the contributor of real estate to a real estate shelter trust will generally receive a tax deduction for at least ten percent of the value of the assets contributed.

Consider the earlier example where Rick sold a property for $1.5 million. If Rick contributed the $1.5 million value property to a properly structured real estate shelter trust, the trust could immediately sell the real estate, recognizing the entire $1.5 million. The trust would owe no tax, and so it would have $1.5 million to invest in a diversified portfolio of assets. In addition, Rick would receive an income tax deduction in the year the real estate was placed into the trust.

To qualify as a tax exempt trust, the trust must meet certain rules.[15] Key among these rules are that the contributor may retain the right to an income stream, not less than 5% per year, from the trust for a period that can last a very long time, but generally not more than about sixty years. The contributor gives up the right to the trust principal, and keeps the right to the income stream. At the end of the trust term, which will usually be well after the end of the contributor's life, the balance remaining in the trust can be used to establish a charitable legacy for the contributor.

*Asset Protection*

In addition to the tax benefits of a real estate shelter trust, because it is a trust, a real estate shelter trust can include a spendthrift clause which under certain circumstances will protect the trust assets from any claims that might be brought against the trust income beneficiaries. This extra benefit comes for free if the trust is properly drafted.

*Ability to Provide For Children, Grandchildren*

A real estate shelter trust can be structured so that after the original contributor, and spouse, die, the contributor's children can receive the income. In some cases, even the contributor's grandchildren can be in line to receive income. There is no stated maximum possible term for a trust, but the expected life of most real estate shelter trusts would be in the range of fifty to sixty years.

*Payouts and Trust Term*

The stock owner who contributes stock to a real estate shelter trust can decide who is eligible to receive payouts from the trust. Typically, the owner will retain the right to receive payouts, usually 5% of the trust value each year, for life. The owner's spouse can also be a beneficiary, and in the vast majority of cases the trust can last for at least the longer of the spouses lives.

In addition, in most cases, the owner and/or spouse can also name one or more children, or nieces or nephews (or anyone, really) to be a successor income beneficiary. In some cases, depending on the ages involved, grandchildren can also become beneficiaries after their parents and grandparents are no longer living.

The expected term of most real estate shelter trusts is determined by the length of the lives of the beneficiaries, and by reference to actuarial tables. In the typical case, the expected life of the trust will be 50 to 60 years. At the conclusion of the trust term, the trust assets can be used to fund a legacy charitable endowment, which can be administered by the

15 The full rules are in §664 of the Internal Revenue Code. These rules have been present since 1969.

owner's grandchildren.

*Deferral Option*

A properly constructed and properly managed real estate shelter trust can provide a period of tax-free deferral during which no payments are made to the beneficiaries, and instead the assets grow, inside the trust, tax-free.

When this deferral is in place, the trustee maintains a bookkeeping account called an accumulation account. Each year while deferral is occurring, the amount that would have been eligible to be paid, but wasn't, is added to the accumulation account. For example, if a trust could have paid out $50,000 a year but is in deferral mode for five years, after five years there would be $250,000 in the accumulation account. If after five years deferral was no longer desired, this accumulated amount could then be paid, in whole, or in part, in one year or over multiple years. In addition, the annual payment from the trust could be paid on top of the accumulated amount.

*Professional Management*

Real estate shelter trusts should be managed by professionals. The management is frequently split between a trustee who attends to all the trust-specific compliance, accounting, reporting, and tax returns, and an investment manager who handles the investments.

*Tax Reporting*

A real estate shelter trust is a separate tax-reporting entity. Even though the trust itself is tax exempt, it must file tax returns. These returns might be quite complex, but such complexity does not affect the income beneficiary.

Each income beneficiary will receive a tax form k-1 from the trust. These forms are typically one page of information.

*Tax Treatment of Payments*

Section 664 provides that a real estate shelter trust keep track of four "buckets" of income. These buckets, roughly speaking, are 1) ordinary income 2) long-term capital gains 3) tax-exempt income and 4) trust capital.

When a trust earns income, that income goes (in an accounting sense) into the appropriate bucket. When the trust makes a payment to an income beneficiary, the tax law says that those payments are deemed to come first from ordinary income, until that bucket is empty, then from long-term capital gain until that bucket is empty, and so on.

*Limitations*

The income beneficiaries of a real estate shelter trust do not have access to trust principal. For example, if an owner contributes $1 million to a trust, that owner will have the right to the income payout, usually 5%, for life, and the life of a spouse, and then potentially the lives of one or more children, and even grandchildren. But the trust principal itself is no longer belongs to the owner.

In other words, after the owner contributes real estate to the real estate shelter trust, the owner goes from owning the real estate outright to owning the right to a stream of payments from the trust. This stream of payments is a capital asset. There is a secondary market for streams of trust income, and under some circumstances it is possible to sell this right.

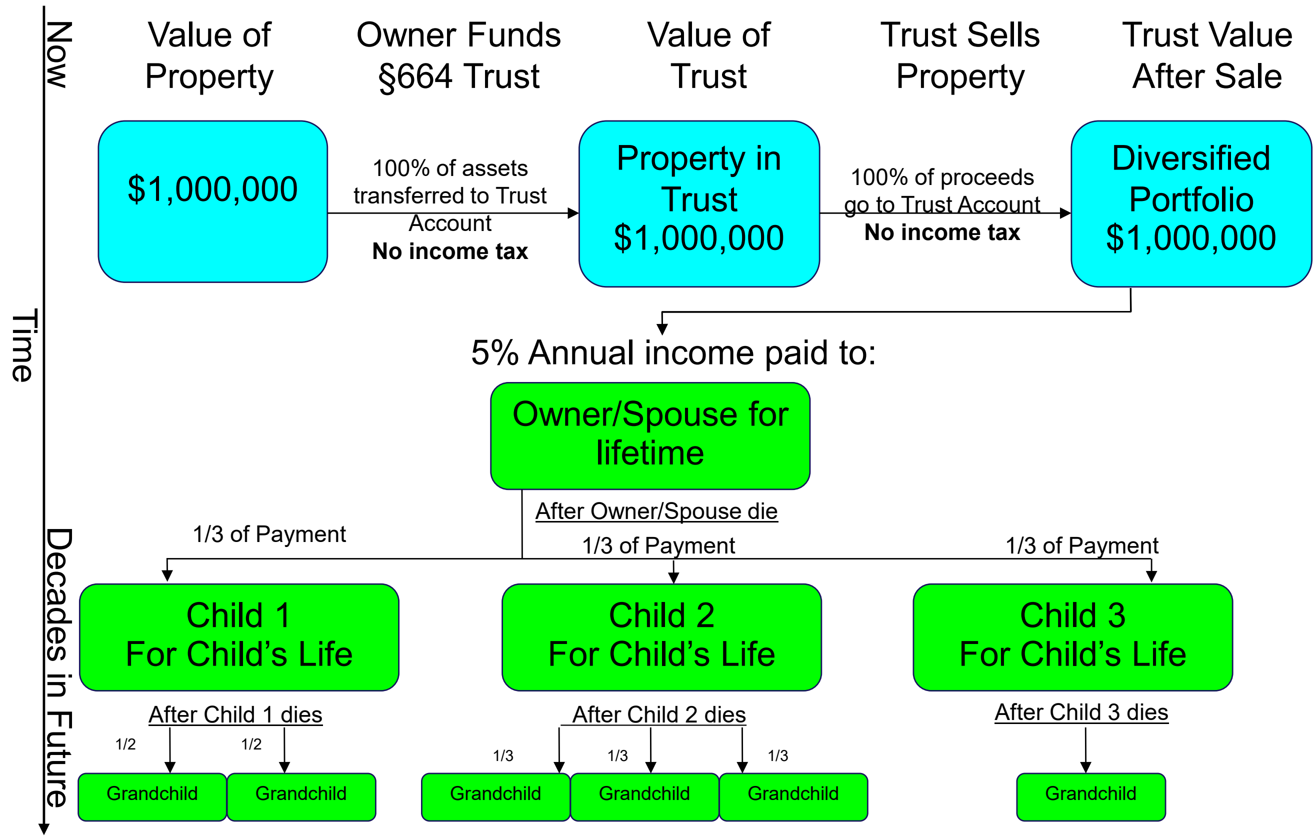
*Costs*

The costs to create a real estate shelter trust can vary from about $1000 if the trust is prepared by someone with a great deal of experience and efficiency, up to $20,000 or more for a lawyer working on a bespoke trust. Ongoing costs will generally include both a trustee fee and an investment management fee. A 2019 survey by the Trust Advisor reported that the average annual fees charged by ten trust companies on trusts up to five million was 0.53%, with an annual minimum of $5210. Those fees have likely risen since then.

*Example*

Below, you can see an example showing how a real estate shelter trust could work in a given scenario:

## Example Use of §664 Trust for Real Estate Diversification




This is an example only, and does not necessarily represent any specific client situation. At the conclusion of the life of the last beneficiary, or the final term of the trust, the remaining assets will go into a donor advised fund account. The term of each trust will be a function of the ages of the beneficiaries living at the time of the client's death, and the applicable IRS tables and rules.

*Choosing a Solution*

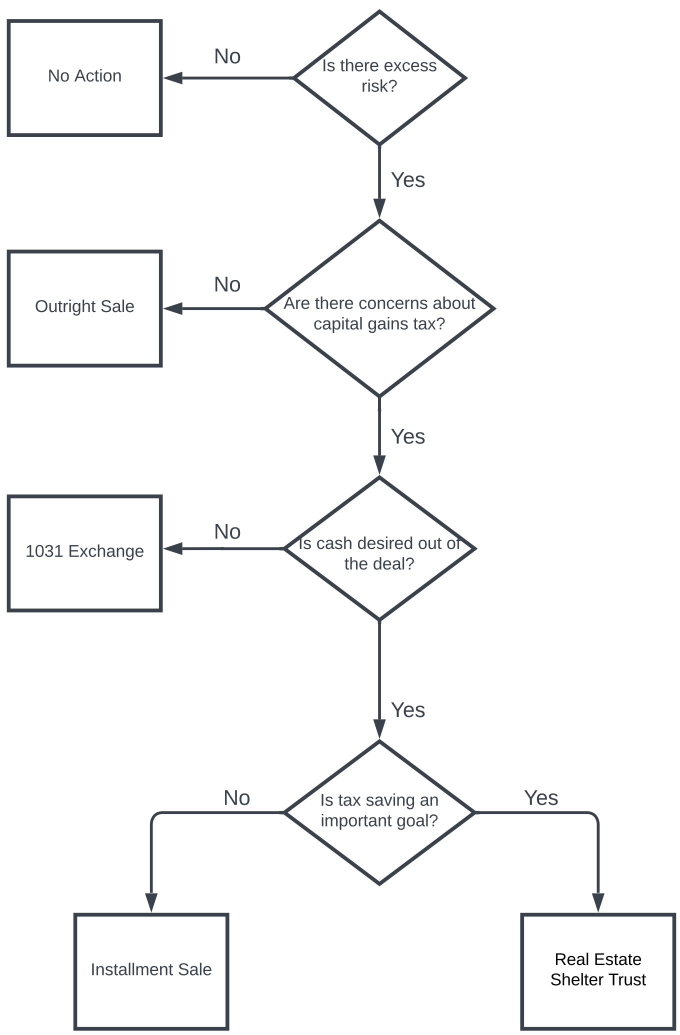
For most holders of appreciated real estate, the following set of questions and answers will help identify the most appropriate solution. These questions and answers are visually represented as a flowchart on the subsequent page.

Is there excess risk from a concentrated position?
  NO — No action needed.
  YES — Continue to next question.

Are there concerns about capital gains tax?
  NO — Consider selling outright.
  YES — Continue to next question.

Is cash desired out of the deal?
  NO — Consider a 1031 exchange.
  YES — Continue to next question.

Is tax saving an important goal?
  NO — Consider an installment sale.
  YES — Consider a Real Estate Shelter Trust.

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# Important Information

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