Mary Vandenack provides the transcript from Legal Visionaries podcast on Alternatives to 1031's – Real Estate Shelter Trust.

TRANSCRIPT:

Mary: On today's episode, my guest is David Murray. Dave joined me previously for an episode where we discussed selling appreciated assets using tax-exempt trusts under Internal Revenue Code Section 664. I asked Dave back to continue to expand, and we're actually doing a series of four podcasts on the issue breaking these down into subtopics. Dave is a vice president of Sterling Foundation Management, LLC, which is based in Reston, Virginia. Sterling manages family initiated charitable entities including private foundations, operating foundations, public charities, supporting organizations, and operates a donor-advised fund in addition to providing philanthropic advisory services. Sterling also provides secondary planning services for existing split interest charitable trusts, including charitable remainder trusts and charitable lead trusts and offers tax-exempt planning services for clients with appreciated real estate, concentrated positions, and business interest.

Dave has over two decades of experience in charitable planning, works extensively with trust and estate attorneys, accountants, and financial advisors. He has bachelor and graduate degrees in engineering, an interesting background to do CRT work, and an MBA, is married with two children. So again, this episode today is going to be talk about alternatives to a 1031 exchange using a real estate shelter trust. Thanks for joining me again today, Dave.

David: Mary, thank you so much. It's great to be here.

Mary: So our first podcast was about selling the appreciated assets and we were talking about using tax-exempt trusts, and so we're going to do a little bit of a deeper dive here today. Is that kind of on track?

David: Yeah, that sounds great. That sounds great. So a real estate shelter trust is a tax-exempt trust under section 664, Mary, that's specifically useful for anyone that has appreciated investment real estate they would like to sell.

Mary: And that's really common, right? Somebody buys, let's say you buy an apartment, small fourplex early in your life when you just have $1000, you finance it, you maybe pay that off, use that to leverage buy another, and then 30 years later you have a lot of appreciated real estate.

David: That's right. That's absolutely right. Now, many of these individuals, these real estate investors are either looking at a 1031, doing some kind of exchange, or maybe they've already even done one. And so real estate shelter trust, and by the way, this is the name that we've come up with to help frame the conversation in relation to this type of trust. Many are not familiar with this type of trust. Now, if they've listened to the first podcast in this series, they will have received a lot of information about the trust type generally speaking. So, our goal here today is to drill down more and be more comparative when we're talking about use of a real estate shelter trust in comparison to a 1031 or really any other type of exchange option for real estate investors.

Mary: So, one of the things you brought up in the first podcast with this, that this type of trust is tax-exempt, and we want to emphasize that again today.

David: Absolutely. So, if someone has an appreciated investment real estate and they gift it to the trust, the trust can sell the real estate and the trust will not pay tax because it's tax-exempt. And when the client or the individual who's gifting the real estate to the trust, they'll receive a tax deduction. The tax deduction they'll receive is based on the present value of the future amount expected to ultimately go to charity. Now, these are technically charitable remainder trusts, Mary, as we talked about in the first podcast, but we tend to not talk about them that way because many families for whom these trusts are actually incredibly, incredibly useful, they may not have charity as being their number one planning objective. Their focus is typically on their children and their grandchildren. But the financial benefits of these trusts are so significant that they're worth consideration regardless of the charitable inclination of a family with appreciated real estate. And that's really a key message I wanted to get across today.

Mary: So, I have real estate, it's appreciated real estate, and I've decided that I'd like to have some tax deduction and you're talking to me about an alternative to 1031. So, I don't want to pay tax on this. Option one is a 1031, but at some point, for most of these real estate investors, they are looking for alternatives. And what you're saying, this is one. So, I can gift a real estate to a trust, I can take income or not, is what I think we were talking about.

David: That's right.

Mary: Can you clarify that?

David: Yeah, so that's a great point, thank you. So, you can gift the real estate to the trust, the trust can sell the real estate, and then the way these trusts are set up is that the property owners, their children, and grandchildren will have the opportunity to take income from the trust well into the future, but they don't have to. So, 5% is the minimum amount these trusts can distribute each year. So, let's say for example, let's say, Mary, you have some appreciated real estate. Let's say the value is a million dollars. You gift it to the trust. The trust sells the asset. So, you're entitled to $50,000 a year coming from this trust. But let's say you have other sources of income. You don't need the $50,000. You can just simply defer it. You can just leave it inside the trust and you can take it at some point in the future if you want to. And if you don't want to take it during your life, your children will have the opportunity to take it once you're gone, once they're actively set up as income beneficiaries on the trust.

So real estate shelter trusts are really tailor-made for families that own appreciated real estate, they want to very importantly diversify away from appreciated real estate. That's one big difference between a 1031 and a real estate shelter trust is a 1031 keeps you in real estate. But if you want to diversify away from real estate, you want to get out of real estate, then a real estate shelter trust makes a lot of sense, especially if you want to defer taxes on the sale and you want yourself, your spouse, your children, grandchildren to receive income from this trust well into the future. And oh, you do receive an upfront tax deduction. We talked about it in the first podcast, but it's a minimum of 10% of the value of the gift being made to the trust. So in my example with you, Mary, of a million dollar piece of real estate they gifted to a trust, you would receive a minimum deduction of $100,000 by making the gift to the trust.

Mary: So could you potentially give us a specific example of how this might work with some rental properties?

David: Yes. So, we talk to clients frequently who have investment real estate, and we talk about this as a planning option for them. So, John, he's retiring, he's in California, he has a service business. He owns the building. Building's worth about $3.5 million dollars. Now he's 67, he's single, he has no children. What's interesting though is he has six siblings, big family, six siblings, has nieces and nephews, and he wants to help them all out. Of course, John has the option of selling his building. Oh, right, but he would have to pay tax if he did, and he doesn't want to do that. There's no debt on the property and this is an important consideration. If someone's considering using a real estate shelter trust, it's really best that the property has no debt. In John's case, the base of the property was very low. So, if he did sell it, he would just pay a lot of tax. In California, he would pay almost 40% tax. He didn't want to do that. So, this is a really, really interesting situation. What we did is because it was such a big family and he had six siblings, we actually created six separate trusts. So, each trust was set up as one-sixth, one-sixth, one-sixth. Six trusts, one-sixth each. So, what happened was he gifted his real estate into an LLC, and then the LLC was divided into six, and each trust received one-sixth interest in this LLC. And then these six trusts ultimately sold the property. So, the property was owned by the LLCs and the trust sold the property through these LLCs, funding the six trusts. Now the trusts were set up to benefit his siblings for their lifetime and then their children, his nieces, nephews, for I think it was a term of up to 20 years.

Mary: So just a good point here. In the very first podcast we did, we talked a lot about children and grandchildren as the generations. But your point here, sort of a side point, you're really talking about the structure of what the real estate, but is in this example, you're using siblings and nieces and nephews. And I'm just pointing out that the beneficiaries don't have to be children and grandchildren and we live in a world where not everybody has children and grandchildren.

David: That's exactly right and it's a very good point. It's a very good point.

Mary: So in that example that you used, where we split this into six shares.

David: Yes, into six shares. The essence of this is, because it gets pretty complicated in just how it was architected, but the essence of this is we set up separate trusts for each of his siblings and their children really just to keep things simple for the family members. But John was still entitled to get 5% of the income from all of these trusts during his life. So, during his lifetime, his siblings weren't going to get any of the funds, but only when he died would they start taking money. And then when his siblings died would their children, his nieces and nephews, start taking money from the trust. John's deduction, so when he created and funded these trusts, his deduction was around 10% of the value of the real estate he gifted to the trust. So, he received a deduction of about $350,000 and he didn't have to pay tax on the sale. He got to defer that into the future, so he was very happy about that.

Mary: And so I like that you used a California example there and you gave the full tax rate, but part of that's the California state rate, which is I think like 13.38%.

David: 13.3%, that's right.

Mary: It might be higher today, I don't know, but it's typically a very high tax state. So Dave, so you've given that example, and what I kind of like about that is that as I'm hearing about my California guy, he can get out of the real estate so he can use one of these charitable remainder trusts. And that often becomes even those who are totally real estate oriented, start thinking about buckets of different types of income and in these trusts, you can diversify. So, once you sell that real estate in this tax-exempt trust, you can then invest in other types of investments. But I just thought it would be helpful to back up and to make kind of clear why that matters so much, just talk about what the 1031 exchange is.

David: Absolutely. So no, I should note the 1031 exchange is not something we do, and some of your listeners are probably already familiar with what one is, but for those who are not, it's also known as a like-kind exchange or tax deferred exchange. And it's a provision of the US internal revenue code that allows real estate investors to defer capital gains taxes when selling an investment property and reinvesting the proceeds into another like-kind property. So basically, Mary, it's like exchanging the property I have currently for a new property and not incurring tax on that conversion, if you will. But there's a bunch of rules that you have to follow in order to qualify for a 1031. And so, it's just important to emphasize that if someone is contemplating a 1031, that they really should seek professional advice in how to conduct one properly.

Mary: And one of those rules is that 1031 is real estate for real estate and there are very detailed, convoluted regulations defining exactly what is real estate and some of those definitions I find interesting, but the generality is you're going to continue to own real estate probably with a low basis and you keep deferring. And one of the things you did mention is that using these tax-exempt trusts, it's best not to have leverage, but a lot of times there is leverage in real estate, which is kind of how real estate works. But then you kind of continue to build a long-term estate and income tax issue, so some of this is some long-term planning to look at some alternative strategies. If you were to compare and contrast, say a real estate shelter trust and a 1031 exchange, what would you add?

David: Well, I would say a 1031 exchange is exactly that. It's an exchange of your current property for another property, so it's keeping you in real estate, whereas a real estate shelter trust is allowing you to diversify away from real estate. So, I think that's really the big difference. I also think familiarity is a big difference. It's interesting when you talk to members of the real estate community, there tends to be a lot of awareness about a 1031 and what that means, but there tends to be not much awareness about these tax-exempt trusts. And we tend to think that's simply because of these trusts being classically referred to as charitable remainder trusts and real estate investors may not be thinking about the non-charitable benefits these trusts can offer them. So, I would say many, many investors are just simply aware of 1031s where they're not aware of these types of real estate investment trusts that we're talking about today.

Mary: And so we're hearing some change in just what you've done in calling them real estate shelter trusts is helpful because there does seem to be a recent trend for longtime real estate investors to be looking for some alternates to 1031. And you're right, if you just refer it as a charitable remainder trust, then that might not even be something that's going to be on their radar.

David: That's right. That's right. Absolutely. So, a way to think of these trusts would be a way to diversify away from real estate holding, defer tax on the sale, and set yourself and your family up for income into the future. And I really do think if someone has interest in exploring one of these trusts, talk to your estate planning attorney, talk to professionals and get some good advice about what would be the best option for you.

Mary: And really kind of overall objectives, right? Diversification, income tax objectives, estate tax objectives. But another thing I think that you've mentioned is the impact on heirs is an important consideration. How does that play into this?

David: So, the impact on heirs is an important consideration. It mostly relates to how to provide for those heirs. Of course, if someone owns real estate and they pass away, they may receive a step-up in basis or their heirs, I should say, may receive a step-up in basis for that asset. But with these real estate shelter trusts, it's a way to solidify, if you will, the planning in relation to your heirs because it's all written into the trust agreement. It's all written in there who's going to get the money and when they're going to get it. And so it kind of solidifies the planning. So, we like to think of this as sort of long-term planning with current day focus in relation to a specific appreciated asset, in this case real estate. So, it's a way to look at real estate in a planning context for many, many decades into the future with your family and their planning needs by having this trust agreement being drafted in a way that reflects your desires and the needs of your family into the future. Principally around income planning for your family members, giving them access to this income, but also in terms of tax deferral for yourself as the property owner today.

Mary: So income's an important consideration.

David: Income is a very important consideration, yes. Now remember, this is something that's very important. I do want to emphasize this. These trusts are merely tax deferral vehicles, okay? They're not tax avoidance vehicles. So, at some point when income is distributed from the trust, the income beneficiary, either you, your spouse, your children, your grandchildren, they're going to have to pay tax on the distributions, but only if and when they take income from the trust. If there's no income taken from the trust, there's no tax paid. The tax correlates to the income, and more specifically the character of the income under section 664. And we've talked about this in the first podcast with the four tiers of accounting. But suffice to say that these are tax deferral vehicles, they're very powerful tax deferral vehicles, but ultimately if income is taken from the trust, tax will need to be paid on the distributions.

Mary: So we talked about the 1031 exchange and this type of trust is an alternate to that, what are the other types of things that real estate owners do look at when thinking about selling real estate?

David: Well, it's funny, because we had a conversation the other day with an advisor. His client had a very sizable piece of real estate, highly appreciated, low basis, and the client just elected to sell it outright. Didn't do any tax planning, just sold the property outright, paid tax on the sale. So, an outright sale is always an option that's available to a real estate owner. Of course, most real estate owners are looking to not pay tax and that's why a 1031 has become so popular with many real estate investors. But another option that we're familiar with is an installment sale where an agreement's put in place to sell a portion of the asset over time, and in some cases, it can reduce the amount of tax the property owner would need to pay. So, I would say an outright sale and an installment sale are really the two other scenarios that we've seen, Mary, or we hear about other than the 1031 or real estate shelter trust.

Mary: And there's some drawbacks of the installment sale?

David: There are some drawbacks of the installment sale. The interest payments to the seller are taxable as ordinary income. The seller becomes a creditor of the buyer and thus will be reliant on the buyer's ability to make the note payment. So, when you do make an installment sale, you're relying on the credit worthiness of the person you're selling to. And when you do an installment sale, you don't have access to the full sale amount today. You must wait and get increments of the sale amount over time and some families don't like that; they want to have access to the whole principle today.

Mary: And so, this concept of the monetized installment sale evolved to try and help sellers have access to, but that's one of IRS's target transactions, so the typical installment sale is an accepted strategy, but does limit the access to that principle. So, if you were to summarize key benefits of the real estate shelter trust, could you summarize those in a bullet point list for us?

David: Absolutely. Tax deferral while diversifying away from investment real estate, providing income to family members with the ability to defer income into the future, and of course, asset protection. We touched on this in the first podcast. These trusts are typically drafted with the spendthrift provision that ultimately can protect the asset within the trust from creditors. So, asset protection is an important consideration.

Mary: And I think you know Marty Shenkman, who's been on a few podcasts and we do a lot together, and what he says about asset protection is that's almost an overlooked benefit of trusts in general and that the asset protection in general provides protection from divorcing spouses, from creditors, you get sued by somebody, a whole bunch of scenarios, and I think it's a huge benefit of a lot of these trusts.

David: Completely agree.

Mary: I'm sure there's some disadvantage of these trusts. What would be the disadvantages? So, a lot of times when I'm talking to a client, they're like, why would I not want to do this?

David: Well, if the real estate has debt on it, we would discourage someone from considering one of these trusts unless it's a very small amount of debt in relation to the value of the property. So that's one thing I would mention. A real estate shelter trust is not a good idea for someone who wants to gift their primary residence and continue to live in it. These types of trusts are really best for investment real estate that the client wants to sell.

Now, if a client has rental properties with no debt and they want to gift them to a trust and have the trust retain these rental properties, that's probably going to be fine. The thing is, the income generated by these properties would need to meet the distribution requirements of the trust. So as long as that's in place, it should be fine. But I will tell you almost universally, Mary, situations we've seen where property investors have used these types of trusts, it's really in seriously contemplating the immediate sale of the property and not retaining the property for income purposes. So, I would submit that anyone looking to sell the property with little or no debt should really, really take a hard look at this type of trust. I think it could be very beneficial to them.

Mary: And I had a footnote that earlier you talked about this being a long-term planning strategy, and I always talk to people about exit plans should be in far in advance of your planned exit, because if you plan this ahead, leverage in real estate is super common. But if you start thinking about this as one of the strategies, you can start to look at what piece of real estate makes sense and how can I remove any of that debt so it's a good asset for this as opposed to, okay, let's just do this now type of thing.

David: Absolutely.

Mary: Are there any restrictions on the type of real estate that can be put into one of these real estate shelter trusts?

David: No. I think as long as there's little or no debt, it should be fine. One thing I would note in terms of the timing of these sales, because we have, and I'm sure you've gotten these phone calls as well, we get a phone call, someone already has a legal obligation to sell the real estate, and they're like, look, can you guys help us get one of these trusts in place? And we're like, I'm sorry, no, we cannot. So, the rule is there cannot be a legal obligation in place to sell the property before the property is gifted to the trust. So Mary, you pointed out the importance of long-term planning. If someone's looking to use one of these trusts in association with the sale of the real estate, the real estate should be gifted to the trust before there is an obligation to sell it. So, it does require proactive planning in order to successfully utilize one of these trusts.

Mary: So do you have any last thoughts on this topic today, Dave?

David: Mary, I just really want to encourage anyone considering selling their investment real estate to evaluate all their options. If they want to sell their property, defer taxes, and stay invested in real estate, then you know what? A 1031 exchange could make a lot of sense for them. If they want to diversify away from real estate while giving themselves and their family members access to income well into the future, it would be a good idea to consider a real estate shelter trust.

Mary: And I think, Dave, you're always willing, if I believe, and we'll put your contact information when we release the episode, but just to share it, I think you're willing to take calls just on this concept. And you're available at (703)997-4717, and David.Murray@sterling-foundations.com, which again will be listed with the episode. Well, as we reach the end of today's episode, I want to thank our sponsors: Interactive Legal, Veterans Victory, Foster Group, and Carson Private Client. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.