THE LITTLE RED BOOK OF RETIREMENT

Passive Real Estate Investing

EVERYTHING

you need to know about DSTs and 1031 Exchange.

PRESENTED BY DAVE LOPEZ

The Little Red Book

OF PASSIVE REAL ESTATE INVESTMENT

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FOREWORD

By Dave Lopez

In my professional experience, there are 2 types of investors. (1) Those who understand the power of real estate, and (2) Those who do not. For those of us who do understand, including real estate as an asset class in your wealth building strategy is important because it can give you the ability to build wealth, defer taxes, and generate an income stream while diversifying away from the stock market.

When it comes to getting advice on including real estate into your overall investment strategy, many of you have been, "on your own". That's likely because we have all had a similar experience of visiting with a financial advisor only to hear them talk about stocks, bonds, mutual Funds, annuities, and possibly life insurance.

The fact is many advisors do not have the training, experience, or incentive to discuss real estate with you. As a result, they may not discuss your real state holdings at all, or they may encourage you to liquidate them and invest the money, "with them", in the stock market.

I have been blessed to grow up with a father who built his wealth in real estate, one property at a time. He impressed upon me the value of a "Hard Asset" that will always have value. Dad said he loved real estate for 3 reasons:

1) You actually owned something other than a piece of paper Your property would always be worth something.

2) You were dealing with other "Real People" with real lives, real emotions, real prob lems, and real needs. As a result, with patience you could find a deal that was a win/win for both of you. Dad felt this was in stark contrast to investing in the stock market. In the market, Dad said, "you are competing with professionals who have access to more information than you" and he did not like that disadvantage".

3) With minimal training you could easily understand the numbers in a real estate deal. This allowed you to evaluate the deal and identify if it was a good fit for you. In

contrast, with the stock market, you often bought or sold based on advice from a broker, news article, or Sunday morning guru. All the while never really under standing the intricate "numbers" behind the success or failure of that company or "that group of companies" if you are in a mutual fund.

Growing up with a "real estate" Dad gave me a unique perspective on the investment world. As an adult, I have bought and sold many properties, held some for rental income, flipped some for quick profits, and even renovated some. I have experienced both the good and the bad.

My takeaway is that real estate investing needs to be treated as a business. Those who think they can buy a property like they would a mutual fund, sit back, and watch it grow usually lose money and never go back. It takes work to manage your properties, late night calls, changing out toilets, evicting dead beat tenants, covering expenses while your property is in-between tenants, and more. If you can successfully manage that work, and don't mind doing it, real estate can be fruitful.

Unlike other businesses, most of us have never been presented with a viable, "exit" or retirement strategy from our real estate business. If you sell, you can lose your income stream, get killed with capital gains taxes, and the resulting "Net Proceeds" now have to go into something. But finding another investment that can do what your real estate did can be daunting. And, you likely lost a large portion to taxes.

If you hold the real estate until you die, you can avoid the taxes as your heirs receive a “Step Up in Basis” at death. But this requires you to remain a landlord for the rest of your life. Most of us do not want to be on call 24-7 in retirement, chasing down rents, fixing appliances, and repainting walls.

The good news is there is a solution, Passive Real Estate Investing and the 1031 Exchange. This brilliant strategy allows you to remain in real estate, continue to receive your monthly cash flow, keep the security of a hard asset, and do it in real estate, a market you love and understand. In addition, this solution allows you to retire from the landlord business forever, while continuing to receive all the benefits of your real estate including:

1) Residual income stream.

2) A hard asset you can pass on to your heirs.

3) Tax deferred appreciation of your property.

4) Tax free appreciation of your property if you pass it on to your heirs.

5) Enjoy professional property management by a qualified, vetted, and experienced team.

Passive Real Estate Investing is the "Landlord's Exit Strategy". You maintain real estate assets, while giving you the opportunity to retire from the business of:

1) Changing toilets.

2) Painting and carpeting your homes

3) Late night calls.

4) Begging for late rent checks.

5) Costly and time consuming eviction processes.

6) Onerous Renter friendly landlord laws that cost you time and money.

Our firm builds out unique, comprehensive individual retirement plans for our clients. As a Computer Science and Math Major, I am an analytical thinker by nature. Over the last 10 years, building hundreds of retirement plans for my clients, I created a systematic process to methodically design a retirement plan based on your individual goals, risk tolerance, and needs. My system addresses concerns identifies the investment tools that would be the best fit for your goals and shines a light on the advantages and disadvantages of all options so that we, together, can make an educated decision.

Unlike almost all other advisors I have met, our firm passionately believes real estate should be included as an integral part of your Retirement Strategy.

But Passive Real Estate Investing is not right for everyone. If you love changing toilets and repairing homes, then it's probably not a good fit for you.

If, on the other hand, you have one or more properties you would love to get rid of if you could only:

1) Defer or avoid the capital gains tax

2) Continue to receive an income stream

3) Keep your money in the real estate market

4) And do it without any of the landlord headaches

Then, you owe it to yourself to explore this valuable investment strategy. Not many investors know or understand this powerful strategy, but more are learning every day and you do not want to be behind the curve when it comes to innovative ideas.

This Little Red Book of Passive Real Estate Investing is a starting point for you to begin to obtain the knowledge you need to make informed decisions about this incredible Real Estate Strategy. I encourage you to read this book with an open mind and begin to think differently about your real estate and overall plan for retirement.

Read, study, and critically review the information in this book. Feel free to reach out to me with any questions. You can call or email for more information on how you could use this strategy, or how you could take advantage of it to help create more time and less stress in your retirement.

Wishing You Many Successes in Retirement!

Sincerely,
Dave Lopez

Dave Lopez

Dave Lopez
Founder of ILG Financial
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INTRODUCTION

Why Passive Real Estate Investing?

In this book we will explore the area of passive real estate investing. First, we should define what that means. Probably the easiest way to define this is by saying what it does not mean. Passive real estate does not mean you deal directly with the “Terrible T’s”. The terrible T’s are what an active manager of real estate, or a landlord is responsible for including toilets, tenants, trips to Home Depot, termites, and time spent. Many people like being real estate investors, but do not like being a landlord, have the time to spend on it, have the skill sets necessary to do it well, or have the energy. In addition, many people have Qualified investments in retirement accounts, only allowing for passive real estate ownership.

Why active real estate investing?

Often, the potential upside is greater with active real estate than with passive. If you understand the markets and are able to know when a property will appreciate greatly, you can make large gains. Maybe you are a handy person, or can remodel in a way to add value. Perhaps you know of future growth plans for a neighborhood or you are adept at construction. What if you are able to use OPM (other people's money), then you may use leverage for big gains. Generally, if you have what I call a "value add proposition" you are bringing to the deal, then this can be a better way to go.

However, what if you are good at all of these, is that all that matters? The easy answer to this is NO. Owning active real estate has a life cycle to it. What I mean by that, is if you are adept in these areas and are 20-50 years when a property will appreciate greatly, you can make large gains. Maybe you are a handy person, or can remodel in a way to add value. Perhaps you know of future growth plans for a neighborhood or you are adept at construction. If you are able to use OPM (other people's money), then you may use leverage for big gains. Generally, if you have what I call a "value add proposition" you are bringing to the deal, then this can be a better way to go.

CHAPTER ONE

Pros and Cons of Passive Real Estate

Let's summarize some of the potential positive attributes to owning passive real estate:

1. ***Quality of life.*** *Given the choice of being free to go on an extended cruise for your 75th birthday, or having to stay home in case a tenant has a complaint is really no choice at all. Being a real estate*

professional or landlord is often a hard and time-consuming job. Many of my own clients are very skilled at making profits in active real estate, but what's the point if you never have the freedom or time to enjoy yourself in retirement? On my radio show, I often use the saying "I've never seen a hearse pulling a U-haul".

2. Diversification. *Maybe you feel good about the area near where you live, but are concerned about having all of your holdings in one geographical area. In addition, prices may have appreciated greatly, so you are concerned buying nearby isn't timely. When using effective passive investment strategies, you can diversify around the country, pick an area of the country, or invest worldwide. You can choose the types of properties, underlying debt leverage, and average age of properties amongst many other attributes.*

3. Potential of near term income tax savings, as well as enormous potential permanent tax savings to your spouse or heirs. *One of the most advantageous tax deductions is through depreciation. The tax code assumes the value of your real estate goes down every year and allows a deduction offering a refund. However, most real estate goes up in value over time. When you sell real estate, tax on depreciation recapture is usually due, however as we will discuss in the section on Delaware Statutory Trusts, (DSTs), this tax can be eliminated with proper planning.*

4. Alternative source of cash flow to bonds, CDs,

money markets, and dividend centric stock holdings. *Passive real estate historically has a higher yield than all of the investments just listed. Retirees have an unprecedented challenge, especially in a low interest rate environment, to generate enough cash flow from their investments to beat inflation. In prior decades, interest paid from CDs and high-quality government bonds consistently exceeded inflation. As of the release date of this book, that is no longer the case. In addition is the element of underlying appreciation potential. Money markets and CDs have none. Bonds can gain value if interest rates fall, but lose value when they rise*

Real estate, as an asset class, on the other hand has historically yielded above inflation in almost all markets, and has appreciated in most regions, property types, and during most calendar years. However, as I will discuss later, real estate also has many risk factors. Much of my professional career is spent doing financial planning, including strategies to generate cash flow in retirement. If you don't have access to a pension, then three of the most effective tools I use to create cash flow are passive real estate, passive real estate debt, and Fixed Indexed Annuities with Guaranteed Lifetime Withdrawal Benefits.

5. Non-correlation to the stock and bond markets. *This will be the subject of my next book. Many advisors use something similar to the "rule of 100". For someone 60 years old, this rule says take 100 minus your age and* *invest this into bonds and some cash, the rest in the stock market. This means a 60-year old is often recommended to invest 55% in bonds, 5% in cash and 40% in stocks. This has been an effective strategy for decades while interest rates have been declining. However, in the decades to come, I'm not of the opinion that this cycle will continue to repeat. Bonds lose money if interest rates rise – a very plausible scenario. Given the option, I'd be inclined to give passive real estate a good hard look as an alternative to bonds. Bonds are also often in portfolios because they aren't in sync or correlated to stock markets. But neither are passive real estate or real estate debt investments. Consider this, if you own a piece of a 300-unit apartment complex and the stock markets go up or down by 15%, do you increase or decrease rents? Of course not. Which means your cash flow is not in sync or correlated to the movements of the stock or bond markets.*

6. Rents can raise with inflation, creating a hedge against inflation. *This is an often, overlooked advantage to owning passive real estate. As previously mentioned, increases in interest rates are Kryptonite to bonds. However, most real estate investments carry loans, otherwise called leverage. Most of these loans have a fixed interest rate for an extended period of time. Rental increases to many real estate holdings increase more rapidly when inflation exists. Landlords raise rents, but banks can't raise interest rates on fixed rate loans. So, while bonds are losing value real estate is often improving its cash flow.*

7. Professional management. *So often, people are* *looking to cut costs of professional fees. First hand, I witnessed the effects of a person worth $10 million deciding to save a thousand dollars by not hiring an attorney, instead doing his own will. He bought a lawn mower with the thousand he saved. I titled this the "$2 million-dollar lawn mower" in a previous book because that's how much the mistake cost his heirs by leaving out a very important provision in his will. Similarly, income tax planning misses are extremely common. Investors in real estate may have much to gain from experienced professionals knowing when, where and how to invest and finance in the right properties, how to negotiate the best lease terms, when and to whom to sell, and how to maximize rents and minimize costs. Personally, I am very comfortable with the value-add proposition of effective and experienced real estate professionals and real estate investment sponsors.*

8. Opportunity to invest in real estate expected to do well, given the current economic trends. *The only thing constant is change. This applies to real estate investing too. Twenty years ago, home ownership was on the rise, retail sales were booming as well as office rentals. Today, millennials are focused on high-end (Class A) apartments, their garage is a self-storage unit, health care facilities service aging baby boomers, successful industrial parks cater to internet sales, and data storage facilities are expanding exponentially. Real estate needs have changed dramatically. The advice of someone experienced with this can be crucial.*

As with every potential investment option, there are positive and negative attributes. Many negative attributes can be mitigated, or minimized by certain steps, but even so, they can still exist. Now let's examine some of the potential risk factors of passive real estate investing.

1. ***Too much leverage.*** *You may find the next few paragraphs profound as it sums up the reason for the Great Depression and the Great Recession in one word: leverage. In 1929, the stock market was booming, all you needed was 5% down to buy stocks. So, if you invested $1,000 in a stock, you controlled $20,000 of that stock. If the stock increased by 10%, your $1,000 investment was now worth $3,000 minus any interest expense on your margin loan. In 1929, on Black Tuesday, the markets dropped on average over 13%. If you had 5% down, you owed the difference of 8% back to exit the market. Problem was that most investors had no other funds, margin calls were uncovered by investors, and the whole system collapsed into the Great Depression. Later, in 1933, the rules were changed to require 50% equity at all times instead of 5%.*

Fast forward to the early 2000's. Congress in its infinite wisdom decided all Americans should be able to buy a house, so they relaxed historical lending standards. Instead of 20%, or even 5% down, many home sales required zero down payment. Major banks got caught up in this greed cycle and allowed lending for the sake of business growth. As I often say, the requirement to buy 10 rental houses was that the borrower needed a pulse! With any retreat of real estate values, borrowers had negative equity and often decided to walk away from their commitments, causing the Great Recession of 2008.

Leading up to 2008, many passive real estate sponsors similarly leveraged properties very high. When times were good, leverage made these sponsors look like geniuses. However, when the real estate markets plunged 20-40% virtually overnight, they collapsed. Beware of deals promising exceptional returns, often you are just taking on exceptional risk.

Several times, I've been told by prospective clients something like the following. "Brian, another investment guy said I would average 20% per year without any risk, why would I go with you?" I typically just ask "does this make sense to you?" I'm pretty sure if no risk investments with 20% returns existed, nobody would need to be "selling" the concept to you given there is over $100 trillion in the global markets earning under 1% currently.

2. ***Poor property diversification (type, location, timing).*** *Unlike the stock market, diversification in real estate is more than spreading out to all offerings. Twenty years ago, shopping center and office parks were a great choice, especially in the Northeast. Today, perhaps Class A multi-family, self-storage, health care, and data centers in the sunbelt states might make a whole lot more sense moving forward.*

3. Unproven manager of the investment. *Personally, I've been a CPA for over 30 years, with a few keystrokes, I can make projections of future performance sparkle or fizzle. Make sure to challenge any unproven source and consider putting more trust in working with experienced and proven winners. Do not blindly trust models that project great wealth with limited risk, challenge it or get a trusted source to challenge it on your behalf.*

4. Investment advisor advice (most are told what to sell and don't fully understand risk and return factors). *This ties in with my next piece of advice. I recommend working only with advisors that truly understand their own advice. If someone is paid to sell something, that remains their conversational objective. Make sure you can adequately challenge their knowledge by becoming informed on the subject matter.*

5. Dealing with investment advisors that are commission based (they are not required to act in your best interest), *or Fiduciary Advisors that don't research or intend to service the investment. Non-Fiduciary advisors work for something called a broker-dealer and charge a commission for a sale. Often, they offer limited service after the sale, and don't have adequate product knowledge. Similarly, many "Fiduciary" advisors offer to act in your best interest, but may not fully understand investment choices. Be selective in whom you choose as your advisor.*

6. Lack of liquidity. Some passive real estate investments allow potential liquidity after one year, while others may require you to wait up to 10 years. The longer term wait periods are usually associated with DSTs held for a purpose, this will be discussed later in the book. This isn't necessarily a bad thing, especially if you plan on a long retirement and don't need all of your assets to be liquid all of the time. 7. Lack of control. Passive investing literally means giving up management control in exchange for freedom from those decisions.

CHAPTER TWO

Types of Passive Real Estate Equity Investments

Successful real estate investing is tied closely to successfully determining many factors. One very important factor is the type of real estate. Economic and demographic trends change over time. Thirty years ago you might have been quite happy with investments in big box retail shopping centers and office buildings, but shied away from inner city apartments because of the rise in home ownership.

1. Residential real estate:

a. Rental houses (labor intensive, high potential appreciation)

b. Apartment buildings (inflation hedge, good potential appreciation)

c. Townhouses

2. Office buildings (low maintenance, risk of vacancy from tele-commuting trends)

3. Industrial

a. Warehouse distribution centers (low maintenance, boost from high internet sales)

b. Self-storage (very low maintenance, garage for many apartment dwellers)

c. Special purpose business buildings

4. Retail

a. Shopping malls (on a serious decline)

b. Strip malls (risk from tenant departures)

c. Retail storefronts (risk from changing buying environment)

d. Grocery stores (location and strength of lease vitally important)

e. Specialty stores

5. Mixed-use real estate

a. Hubs containing several business types within integrated structures

6. Student Housing (micro apartments on the rise)

7. Medical service delivery such as surgery centers and hospitals (high growth due to aging baby boomers)Consider whether a fixed-indexed annuity may suit your retirement needs.

8. Mission Critical businesses

a. I.E. Data storage centers (one of the fastest growing industries)

9. Hotels (location, location, location)

CHAPTER THREE

Delaware Statutory Trusts (DST's) & Tax Deferred Exchanges

There is a major dilemma facing many Baby Boomer investors today. Their successes in real estate have also had an adverse effect on their quality of life. What is the problem and is there a solution? Let's start with the problem: a "good problem" to have. Twenty to forty years ago, you may have opted to purchase a small apartment complex or several rental houses as you ventured into rental real estate. While this can be a great strategy to build wealth for someone in their earlier years of investing, owning actively managed real estate takes a lot of work and is best for a season of your life, not the duration of it.

For example, suppose you bought four rental houses long ago for $100,000 each. They are fully depreciated down to their land portion of $25,000 apiece. Today the houses would net $300,000 each. The problem is that you want to be retired now, but you own these now very old houses needing a lot of maintenance. You cringe whenever you receive a property related phone call because it always seems to be about a problem. Is the roof leaking? Tenant moving out again? Midnight plumbing problem? Or did you just find out your "pet-free" tenant was hiding 12 cats from you when they moved in (true story)? You could hire a property manager, but they are expensive and each of these maintenance problems still costs you thousands to correct, and you still own very old houses!

So you go to your CPA for some guidance, and she informs you that if you were to sell the houses your federal income tax alone will be over $250,000, and that's not including the state tax you may owe. Also, if you sell, your spouse and heirs will not be eligible for the step-up in basis when you pass away. Finally, you will be eliminating a big potential source of retirement income from your portfolio, and you would now need to find a different investment.

Section 1031 of the tax code allows for tax-deferred exchanges of properties where you can sell your real estate, then identify and close on replacement property in 45 and 180 days respectively. The problem with this solution is you would still own real estate that would require active management in your later years.

So can you exchange tax free into a real estate partnership, real estate LLC, publicly traded REIT or private REIT? **The answer is no to all of these.**

But there is a solution. Appreciated rental real estate can potentially be exchanged income tax free for real estate owned within a Delaware Statutory Trust (DST). The advantages of this can be dramatic. With a DST you can diversify by property type, specifically into multi-family apartments, medical office buildings, self-storage or retail. You can diversify geographically by investing into several different DSTs in different areas of the country offered by different DST providers. The income tax of $250,000 could be eliminated for now, and potentially eliminated permanently to your heirs by continuing to hold DST investments for life.

Accredited Investor Requirements

To invest in a DST you must be an accredited investor. To be considered an accredited investor, one must have a net worth of at least $1,000,000, excluding the value of one's primary residence, or have income of at least $200,000 each year for the last two years (or $300,000 combined income if married) and with the expectation to make the same amount this year. An entity is an accredited investor if it is a private business development company or an organization with assets exceeding $5 million. An organization cannot be formed with a sole purpose of purchasing specific securities. Also, if an entity consists of equity owners who are accredited investors, the entity itself is an accredited investor.

The cash flow from DST real estate can be higher than it is from high-maintenance older rentals. These investments are professionally managed and can often be placed into newer properties. Newer properties are eligible for accelerated depreciation using a methodology called "cost segregation." What this means to you is that you could potentially shelter much of your rental cash flow from income taxes.

As with any investment, there are risks, costs, and benefits. For my own clients, we vet potential DST replacement properties through more than 40 data points, including local economic indicators, expected yield after fees, loan leverage and property manager history through the 2008 real estate bust.

Besides the diversification and income tax savings opportunities, you probably picked up on the real advantage. You worked hard your whole life, invested money and countless hours into your rentals, and now you want to enjoy the fruits of your labor without being tied to your “job” as a landlord of older properties. Y**our solution to a true retirement could be found in these three letters: DST.**

CHAPTER FOUR

When to Consider Using a DST?

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 they previously 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. In one scenario these can be sold, and tax of $200k could be paid on the gains. The $800k net proceeds can then be invested in a 1% CD earning $8k per year. Or, Mary may find it more advantageous to invest in a DST using a 1031 exchange. In this scenario the full $1 million may produce cash flow of $40k-$45k per year, no income taxes to pay upon the sale, and Mary still gets to participate 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. That means Mary wouldn't have to take out a loan, and wouldn't be personally liable for any of the debt as this liability is assumed by the DST sponsor.

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 3:** 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 4:** 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.

> **Example 4(a):** 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”.

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

> **Example 5:** 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 6:** 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.

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 7:** Bill felt good about the area where his rental house empire was situated, but was concerned about 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 8:** 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 9: 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 two houses that are a landlord's dream, never a problem, but two others where all his problems originate.

Example 10: 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 11: 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 12: 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 13: 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.

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.

As CPAs, we all have 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.

CHAPTER FIVE

Why is This a Timely Investment Topic?

Investment alternatives can be broken down into 4 primary categories. What is interesting to me is the approximate size of each category relative to each other.

4th Place: Insurance Annuities. Insurance companies can provide various types of annuities. One of the most popular is the Fixed Indexed Annuity. These investments are not designed to have high returns, but may be the best option if your goal is to never lose money in a given year, yet have the opportunity to substantially beat inflation over time.

3rd Place: Goes to rental real estate of all types, as discussed in this book. It's interesting to note that in the retirement plan world of IRA's and 401k's, real estate is commonly missing from asset allocation. Later, I will discuss how it can be used, along with Fixed Indexed Annuities, as a substitute to bond allocations.

2nd Place: Surprisingly to many, the value of the stock market comes in only 2nd. Even with the increases of the markets in recent years, it has not surpassed the top spot.

1st Place: The biggest investment category is with bonds. The US government alone has issued over $20 trillion. Corporations, municipalities, and public entities often raise money by issuing bonds, a promise to pay back principal at a future date with interest along the way.

Why is this important and timely? For years, investment advice has been centered around the allocation between stocks and bonds. Often, I see portfolios split

60% to stocks, 40% to bonds, or vice versa. What about real estate and Fixed Indexed annuities? Should they be considered?

Bonds have historically over the last 40 years done quite well and have a low correlation to movements in the stock market, making them a very good choice over this 40-year time period. But let's examine the future for this investment class with a hypothetic exchange between an advisor and an investor:

> **Investor:** *I'm 60 years old and have $1 million in my IRA, how would you invest my money?*
>
> **Advisor:** *Using the Rule of 100, I'd take 100 minus your age, put that into stocks and the rest into bonds, so 40% in stocks, 60% in bonds. Based on results of the last 40 years, this has achieved the best results combined with low risk and volatility.*
>
> **Investor:** *What kind of bonds will you invest? What should I expect?*
>
> **Advisor:** *Primarily indexed funds of government bonds, 5-7 year average duration, yielding 2.6% on average.*
>
> **Investor:** *What is your fee?*
>
> **Advisor:** *1.25% per year*

Investor: *So, I'd only net 1.35% on average?*

Advisor: *No, we at Edward Lynch believe interest rates on these bonds will increase about 1% over the next 7 years, and if that happens, your net yield will drop to about 0.5% per year.*

Investor: *Your plan for me, if successfully executed, is to invest 60% of my retirement into an asset class that could yield 0.5% per year net, and the other 40% into stocks, currently trading at an all-time high? (as the investor walks out the door!)*

I'm suggesting an alternative to a doomed plan from the outset. Bonds have been used for two primary reasons: non-correlation to the stock market and yield. Consider this, passive real estate and fixed indexed annuities are not highly correlated to the stock market either. Passive real estate has much higher potential yield than most bond portfolios. Fixed Indexed annuities are often contractually obligated to never lose value in a given year.

Rather than limiting our thinking to Stocks and Bonds, having a paradigm shift to open our options to other investment options can be a game changer. Bonds have done well for 40 years because interest rates were so high and have come down. If you believe interest rates will continue to decline, then by all means, invest heavily in bonds. However, if you believe as I do, interest rate declines have run their course, and since bonds lose value with interest rate increases, it makes sense to find alternatives to bond investment allocations. One final comment: many passive real estate investments have secured fixed rate loans. As inflation occurs, rents often increase, mortgage payments are fixed, and the real estate investment results actually improve in an inflationary environment.

CHAPTER SIX

Type of Accounts to Invest

What type of accounts would you consider to invest into passive real estate?

1. Non-Qualified accounts:

What is non-qualified? It is simply an account that is not a tax-deferred retirement account. Tax-deferred retirement accounts include IRAs, 401k, 403b, 457, SEP, SIMPLE, profit-sharing, etc.

Non-Qualified accounts can invest in passive real estate, active real estate, DST's, and real estate debt instruments. Essentially, any investment is eligible in non-qualified accounts.

With respect to DSTs – previously I explained how they can be extremely beneficial when considering a Section 1031 exchange, or a Section 1033 exchange resulting from fire, flood, imminent domain, or other unplanned casualty – there is another opportunity present: cash investment.extremely beneficial when considering a Section 1031 exchange, or a Section 1033 exchange resulting from fire, flood, imminent domain, or other unplanned casualty. However, there is another opportunity from a DST, cash investment.

If you want to invest in real estate for a very long time, and have cash to invest, consider a DST.

> *For instance, Monica is 50 years old and inherited $500k and wanted an investment for appreciation and cash flow. Monica has a great job and is making enough to support her own retirement well, so she doesn't need the liquidity of the $500k. Because*

she is in a high tax bracket, she doesn't want to pay income taxes on the appreciation of her investments, ever! She also wants to leave a legacy to her children and grandchildren someday, and still doesn't want income taxes to be paid on the gains. Monica is in good health, so believes she will live into her 90's.

If Monica invests her cash into a DST, she will be eligible to receive cash flow for life as she rolls sales proceeds into new DSTs (given the current tax law). In addition, all future capital gains from these sales are exempt from current income taxes. With the step-up in basis rules currently on the books, and a hypothetical 3% annually compounding increase in value of the underlying real estate, over one million dollars of potentially taxable gains could be permanently eliminated.

2. Qualified accounts:

Let's start with what is not typically allowed in Qualified accounts: active real estate and DSTs. That leaves passive real estate and passive real estate debt investments.

3. Age 59 ½ 401k type investment

I'm including this, not as a type of account, but as an opportunity. Most 401k plans allow for the ability to move any amount of your 401k balance over to your personal IRA. Why is this important?

First of all, in a 401k plan, you are typically limited as to your investment choices. Even if you are not limited, you may not have a background where you feel confident investing for your lifetime of retirement. Finally, your 401k plan would not have access to the non-traded passive real estate, real estate debt offerings or the fixed indexed annuities discussed earlier. If you transfer 401k balances to your IRA, you open up all these possibilities, and still retain the right to continue to invest in your 401k. I'd call this a "no-brainer" for most.

CHAPTER SEVEN

Non-Equity (Real Estate Debt) Passive Investing Forms of Real Estate Related Investing

Most of this book discusses passive investing in the equity of the hard asset, real estate. Most real estate owned has another investment category associated with it: the debt side. As a real estate investor, you can participate in the rents and gains/losses of the underlying real estate. You can also participate in the lending side. Within the lending side, you typically lend money to an entity that has equity in the real estate and has promised to pay a certain rate of interest. You, as the investor, receive the interest. If the borrower does not perform, you can foreclose and retain the equity in the property. The more equity required of the borrower at the onset of the loan, the better your chances a foreclosure will not occur.

There are many ways to invest in the debt side of real estate. On the active investment side of the coin, you might own a rental house that you choose to sell on an installment contract. Perhaps you required the buyer to give you 20% down, and the remaining 80% is financed by you, keeping the house as collateral, at an interest rate above what you could get from a CD.

There are many forms of passive debt investing, including:

1. **Bonds secured by real estate**
2. **Publicly traded mortgage REIT**
3. **Non-traded mortgage REITs or Senior Loans**

When you invest in these areas, you are basically taking the place of a bank and loaning money against real estate as the collateral. So why doesn't everyone just use the banks? There can be many reasons. One (that is timely to the release date of this book) has to do with the aftermath of the banking crisis of 2008. Prior to 2008, many real estate projects were funded with 5 to 10-year loans. The expectation of the borrowers was they would simply refinance as the loans came due. After 2008, the Federal Government passed many laws limiting the bank's ability to refinance loans even when the borrower had made every payment timely. Hence, a big investment opportunity was created for investing on the debt side of real estate.

One of the most important aspects of investing in debt, is the security or loan-to-value of the collateral. Primarily, investing in debt is done to obtain a high yield, or high monthly cash flow, not for underlying appreciation. A high yield is great, but you have to be confident the principal with be repaid, so the better your collateral, the better your investment.

One form of maximizing yield is to invest in a non-traded REIT, with a credible sponsor, investing in Senior Secured Loans. This is where the sponsor arranges to be in first position should anything bad happen to the company financially. In the case of a bankruptcy, the Senior Secured lenders are paid first, Preferred bondholders next, then unsecured bond holders, and finally shareholders of the corporation stock.

CHAPTER EIGHT

Income Taxes

One of the greatest benefits of most real estate investing is the deductibility of depreciation. Even though the underlying value of your real estate may be increasing, you typically get to take a tax deduction as if it is doing the exact opposite. The IRS is essentially subsidizing your ownership of real estate to a degree. Often however, once you sell the real estate, the tax on the depreciation recapture has to be paid upon the sale. There are ways to defer or eliminate the depreciation recapture. Mentioned earlier was the use of a DST for a Section 1031 tax deferred exchange and the step-up on basis.

The step-up in basis is where most of your non-IRA type assets (non-qualified) get special tax treatment upon your death.

For instance, if you bought a piece of land for $100k, and sold it for $500k the year before you passed away, you would have paid income tax on the $400k gain. If you never sold the property, and you lived in a Community Property state such as Washington or California, the $400k gain is permanently eliminated due to the cost basis “stepping up” to the $500k fair market value on the date of death. In this case, your surviving spouse or heirs could sell the property after your passing and not pay any income tax on the $400k gain. Common Law states also get a step up, but not fully on jointly owned property. Consult your CPA for more specific information in your case.

Another opportunity was created with the new tax law passed shortly before release of this book. Accelerated depreciation write-offs of improvements are now available. Also, there is the potential for the new 20%

reduction of taxable income on your rental real estate properties. The new tax law passed at the end of 2017 was merely a framework from which the specifics of this law will grow. Tax court cases, revenue rulings and other specific situations will be the guide to many of the unanswered questions of the tax law changes. However, it is apparent landlords were granted the same percentage reduction available to many small business owners. This reduction appears to allow owners of rental properties, REITs and DSTs the ability to exclude 20% of their net taxable rental net income from income taxes. As I mentioned, there are many unanswered questions in the new tax law, many that will take years to resolve. Again, consult your CPA for your specific situation related to this opportunity.

CHAPTER NINE

Types of Ownership

There are many forms of entities able to own real estate. I've listed many of them below with attached comments.

1. Individual, jointly, community property, tenants in common, joint with right of survivorship, revocable living trust, common law ownership, etc.

i. These are the most common form for smaller properties, but may not offer any liability protection.

2. General partnership

i. General partners are often personally liable in the case of a lawsuit.

3. Limited partnership

i. If you are the limited partner, you have no say in management.

4. Limited Liability Company

i. This is a very popular form of ownership when possible.

5. S-corp or C-corp

i. S-corps are a pass-through entity for income tax purposes, but C-corps are not, meaning they are subject to a double taxation.

6. Publicly traded REIT (Real Estate Investment Trust) *i. Popular for passive real estate investing, also easy to trade for liquidity purposes.*

7. Non-Traded REIT

i. Not liquid like publicly traded REITs, however can offer exceptional returns with more targeted investment selections, as well as professional management.

8. DST (Delaware Statutory Trust)

i. Eligible for Section 1031 exchanges, targeted investment selection, professional management, but are illiquid.

9. TIC (Tenancy in Common)

i. Also eligible for Sections 1031 exchange, but every owner has to agree 100% on every major decision. Have you ever tried to "herd cats"?

10. Crowd funding

i. Offers low investment thresholds, but is somewhat unproven and often over-promised as to what returns to expect.

CHAPTER TEN

How Hidden Commissions Can Damage Non-traded REITs and DSTs

Over the past few years, the financial services industry has come under criticism regarding fees charged, hidden fees, commissions, 12b-1 fees, and a host of other reductions in the value of their client investments. Much of this criticism is warranted, in my opinion.

A huge topic of conversation in recent years has been around the up-front commission charged by broker/dealers (B/D), who are not held to the fiduciary standard, when they place clients into front-end-load mutual funds. Many savvy investors have discovered how these commissions can take a huge chunk out of their portfolios, and have turned to advisers covered by the fiduciary standard, such as Registered Investment Advisers (RIA), or have decided to self-manage accounts to avoid these up-front commissions.

The investing fees people aren't talking about.

Little has been written or discussed regarding commissions related to passive real estate investments, however. The passive real estate investments I wish to focus on here are private non-traded Real Estate Investment Trusts (REITs) and Delaware Statutory Trusts (DSTs).

In most cases, individual investors cannot simply go into their online brokerage accounts and invest in these type of REITs, nor can they instruct their 1031 exchange facilitator to invest directly into a DST. These investments typically require going through a Broker/Dealer or a Registered Investment Adviser.

The B/D model charges an up-front commission, often ranging from 5% to 8% of the investment amount. Unfortunately, the investment fees are not spelled out on most brokerage statements. Instead the statements show the gross amount, not the net amount available to invest in the underlying real estate. As such, I've known B/Ds to make the false claim that they aren't charging the client a commission at all, saying it is being paid by the sponsor of the investment. Baloney. If an investor puts $400,000 into a DST, and only $370,000 is available to be invested into real estate because a commission of $30,000 was paid to a salesperson, I have news for this investor: They WERE charged a commission. Their confusion is understandable, given the investment is still stated as $400,000 on their statement and the commission is never mentioned.

Investing with an RIA (instead of a broker) could pay off.

Investors choosing to use an RIA will not pay a sales commission charged on their investment. Instead, an asset management fee, stated as a percentage of assets under management, will be charged monthly, quarterly or annually. Using this same example, when the investor puts in $400,000, the sponsor, otherwise known as the property manager, of the DST or REIT grosses up the stated investment amount. So, if you invested $400,000 through an RIA, all $400,000 is available for investment because the $30,000 commission was never paid out of your investment.

In addition, rent is paid based upon the higher grossed up amount when using an RIA. If rents were 5%, the B/D client would receive $20,000 per year. The RIA client would expect to receive this plus an additional 5% on the $30,000 commission that was never paid out, for a total of $21,500. When the investment is sold or otherwise liquidated, the grossed-up commission that was never paid in the first place can be paid to the investor.

A dollars and cents example.

To answer your likely thought; yes, this is confusing. To help explain this concept, I took a look at a real-life situation where an investor sold a rental house, netting $400,000. He decided to invest $100,000 each into DSTs offered by the four largest sponsors in the country. I used the estimated rental income stated by the four sponsors, current commission rates for each, an annual appreciation rate on the underlying real estate of 2%, and an average RIA fee of 0.8% per year.

Most DST investments are held between four years and 10 years. Using the assumptions listed, the following is the cumulative increase in overall investment percentages and overall dollars returned using an RIA rather than using a B/D.

- Sale after Year 4	*+6.1%, over $24,000 more*
- Sale after Year 6	*+5.7%, over $22,000 more*
- Sale after Year 8	*+5.28%, over $21,000 more*
- Sale after Year 10	*+4.89%, over $19,000 more*

It does matter who you use to help purchase non-traded REITs and DSTs. If you agree using an RIA makes more sense than using a B/D, you will also want to consider an RIA who will be there to service your account year after year and is extremely knowledgeable about the various sponsors, products and outlook for real estate sectors in the coming years.

CONCLUSION

A Dedicated Approach for Passive Real Estate Investing

1. All investments have positive and negative potential attributes.

2. All investments have differing levels of risk, reward, loss potential, liquidity, security, correlation to each other, and cash flow. This is why it's important we should consider diversity into our investment mix.

3. Passive real estate investments of all types have been minimally represented in most 401k plans and by most investment advisors.

4. Most professional investment advisors do not have a deep understanding of all aspects of the following investment areas:

US and global stock markets, outlook of future global bond markets, passive and active real estate strategies at a micro level, authoritative income and estate tax strategies, and insurance products offering lifetime cash flow, or annually risk-free investment results. In addition, most people have retirement, legacy and trust implications they would like considered when constructing an investment plan.

Finally, my company, **ILG Financial** is in the investment advisory profession and we are licensed as Fiduciary's. It is our hope this small book has been written in a form where you now have a much deeper understanding of some very complex topics. We do not expect to create experts in the field of passive investing, however it is our hope we have taught enough to start the discussion. We are available to guide you through the potentially highly rewarding world of passive real estate investing.

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About Dave Lopez

Dave Lopez is the founder of ILG Financial, LLC. Dave has been working with individuals and businesses in the Northern Virginia area since 1986. Dave specializes in strategies that enable his clients to potentially build a retirement nest egg that they can rely on and can never outlive.

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