

Retirement Planning for Property Owners “It’s Never Too Early To Retire!”

By Robert Cannon

The vast majority of the investment property owners I know are millionaires. They have all labored diligently for many years to create their net worth. The problem is they don’t feel like millionaires and they don’t live like millionaires because their “money” is actually equity trapped in their properties. The old expression “dirt rich and cash poor” describes their situation. They’ve worked hard for their money but their money is not working hard for them.

There are many benefits to owning investment property including tax deductions provided by the government, the freedom and independence of being self-employed, the opportunity to create wealth for retirement and generational wealth for heirs and beneficiaries.

But, there comes a time when you no longer want the burdens of day-to-day property management. It’s time to stop dealing with the Terrible Ts: Tenants, Turnover, Trash, Toilets and the Termites! The problem is investors can’t retire without selling their property and sometimes that can be a difficult thing to do. Maybe there’s a lot of deferred maintenance, high vacancies or bad local economy. Maybe interest rates are high, money is tight or it’s a buyer’s market and you can’t get a fair price for the property. Maybe you’re scared of selling because you don’t know what to do with the money, you don’t want to pay all those taxes to the government, you can’t let go of the property or you just don’t know what you’d do with yourself if you had all that free time. These are dilemmas that all investment property owners have to resolve at some point in their lives if they wish to retire.

I have some good news for you. There are many options for you to consider and some excellent solutions from which you can choose to deal with this dilemma. They include doing nothing, sell and do a 1031 exchange into a local property, sell and pay the taxes, sell and do a 1031 exchange into a tenant in common property, sell and do a 1031 exchange into a gas and oil and/or royalties program, sell and open a Charitable Remainder Trust (CRT), and sell and open a Private Annuity Trust (PAT).

Let’s start with the obvious, the easiest and maybe the least satisfying. You can do nothing. This option benefits the procrastinators, those who can’t make up their minds and people who don’t like change. They don’t have to go through the process of selling their property and they get to keep the property they know and understand. When they die, their heirs and beneficiaries will get a step up in basis and no taxes will be due, except possibly inheritance tax if they haven’t done adequate estate planning or they have a very large estate. The problems with this strategy are they never get to retire, they never get to enjoy the fruits (money) of their labor, and their heirs and beneficiaries will probably sell the property soon after probate has closed.

A second option is to sell the property and do a 1031 exchange into another local property. In this case, an investor can defer the taxes due at the time of sale and hope to buy a larger property that will provide potentially more income and appreciation. For those who enjoy control, this gives them the opportunity to remain in charge. But they still have the burden of property management (or managing the manager), their equity remains trapped in the property, the return on their equity continues to decrease and their

quality of life has not improved. They have swapped one burden for another, possibly larger, burden.

The third option is to sell and pay the taxes. This option may require the seller to pay the government 15% capital gains tax, 25% depreciation recapture tax, and up to 9% state income tax where applicable. They can invest the sale proceeds in the stock market, the bank, etc. It doesn't take a mathematician to figure out this option may not be a preferable alternative. Most people may not be willing to pay one fourth to one third of their "sweat equity" to the government just to retire, especially after working so hard all their lives to earn their money. They also may not be comfortable investing in the stock market, especially if they have built their net worth investing in real estate.

So, what are the other options, viable alternatives and attractive solutions for these people who don't want to pay capital gains, depreciation recapture and income taxes at the time of the sale of their property? What alternatives will let them stay in control of their money without investing their retirement funds in the stock market? Which options will allow them to stay in real estate but do away with personally managing their property?

For many people, the best alternative is to sell their local property and do a 1031 exchange into a tenant in common property. This enables them to defer taxes due at the time of sale, potentially leverage up to institutional grade investment property with potentially higher returns on investment and appreciation, and then retire from active property management. It allows them to stay invested in real estate which they know and understand. It enables them to enjoy their retirement by providing potential income each month instead of working hard managing their local rental properties. Most of our clients are netting, after taxes, between 2.5% to 4% annually on their local rental properties. Most tenants in common properties in which our clients are invested have averaged better than a 7% annual return on a pre-tax basis. By working less and earning more, your money is now working hard for you. All investments carry an element of risk. 1031 TIC offerings have the usual risks of most real estate transactions such as possible loss of principal or economic risk due to vacancy rates.

Another viable alternative for some investors is to sell their local property and do a 1031 exchange into a gas and oil and/or royalties investment program. This investment is often done in concert with a 1031 tenant in common exchange transaction and is intended to diversify the investor's portfolio. Modern portfolio management theory contends that diversification and asset allocation are important components to a successful investment strategy. Many investors don't realize that Section 1031 of the Internal Revenue Code enables them to sell local rental/investment property, raw land and/or business property and exchange it for certain gas and oil drilling programs and/or royalties. These programs often provide tax and income benefits that contribute nicely to rounding out an investment portfolio. Gas & oil programs carry an element of risk that must be carefully considered by the investor to determine if they are suitable and appropriate.

For investors with an inclination toward charitable giving, the charitable remainder trust is often the vehicle of choice to reduce the tax burden and provide a substantial contribution to the charity of their choosing. It is a time-tested method of estate planning commonly used throughout the country and is preferred by many charities. The CRT does have some disadvantages. If the grantor dies early, the balance transfers immediately to

the charity, bypassing the family/heirs. Additionally, investment choices are limited since the CRT is a qualified plan regulated by the IRS.

Another lesser-known alternative is the private annuity trust which is becoming more commonplace in estate planning. The PAT was developed by the National Association of Financial and Estate Planning, a private association of professional members located throughout the U.S. comprised of attorneys, CPAs, financial planners and investment advisors. In this transaction a deferred taxable exchange occurs after the seller transfers ownership of the property to a dedicated family trust. This is a buy-sell transaction between the property owner and the trust. The form of payment is not outright cash, but a life annuity with fixed and dependable monthly payments. The trust then sells the property to the buyer. This transaction has many benefits including the removal of the entire value of the property from the taxable estate of the annuitant (original owner). When the annuitant dies, whatever is left in the trust passes on to the beneficiaries, completely free of estate and gift taxes.

The key to having a great life in retirement is to be proactive in the planning process. Start early and don't procrastinate. Pay attention to your assets. Select a qualified financial advisor in whom you have confidence and develop a plan. Revisit the plan annually to ensure it's on target and amend it if it fails to achieve your goals. Remember – "It's never too early to retire!"

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