EPISODE 824

[INTRODUCTION]

[00:00:00] ANNOUNCER: Welcome to The Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host, Whitney Sewell.

[INTERVIEW]

[0:00:23.9] WS: This is your daily Real Estate Syndication Show. I'm your host Whitney Sewell. Today, our guest is Kim Dyer. Thanks for being on the show, Kim.

[0:00:31.6] KD: Thanks for having me. It's great to be here today.

[0:00:35.0] WS: Kim is a financial advisor and co-owner of Keystone Capital Management Group, LLC., in Glendale, Arizona. Keystone is an investment and retirement planning firm committed to the growth and protection of their client's assets. As a financial advisor, she embraces opportunity to educate, guide, and simplify the complex. Something Kim is good at and has a method to doing this today is helping you save on taxes, a process we've talked about numerous times on the show is the 1031 exchange. I think most of the listeners are going to be familiar with at a high level what that is, but I think Kim has a different method here that she's going to share with us today that could work for you as well.

Kim, welcome to the show. Give us a little more about who you are and let's dive into this method as far as how we could sell an asset more effectively.

[0:01:23.3] KD: Well, my background is I have my security seven. And I do have an insurance license as well. I have my MBA from the University of Nebraska, and relocated to Arizona. But this is a great program and we work with a company called Dunham & Associates Investments.

And one of the things that they've done is they've set up a Trust Company in Nevada, and Nevada doesn't have state income tax, and they are advantageous to trusts. And so, it's a good location to set up trusts and anybody can use this tool, even if you're living in another state.

[0:02:10.8] WS: Okay, that's awesome. Tell us, I guess a little bit about, what do we call this tool? Or how do we know or how to refer to this, if we're speaking to somebody like yourself?

[0:02:20.2] KD: It's called an intermediated instalment sale. So, I think most of your listeners are well versed on an instalment sale. And real estate people know well about an instalment sale, that there's calculation made at the time of the sale to determine the gain. And you pay tax when you save the cash for that sale. So, this is taking that instalment sale concept and adjusting it slightly to defer the taxes and put you in control of when you pay those capital gains. So, it comes from the same code that the instalment sale code comes. It's section 453 from the IRS code that talks about instalment sales.

One of the things that this judge said — learned at hand, he said, "You aren't required to pay taxes, and that it's not even a patriotic duty to increase one taxes." So, this is a legitimate way to defer paying taxes. It's not something that you should think of as illegal and not able to do or you're not skirting the law. It's in the code. And it's available to every taxpayer.

[0:03:45.6] WS: I want to tell the listener as well that Kim is sharing her screen, she's going through a little presentation with us, she's going to talk about this in a manner that even if you're listening in the gym right now or on a walk or in the car, you can understand what she's talking about. But I just wanted you to know also that you can see this on YouTube as well.

[0:04:04.0] KD: Hey, that sounds great. So, again, what this does is instead of paying the IRS, you're investing that cash so that you're taking advantage of making money on the funds you would have sent to the IRS. And one of the things that the listeners should know is that with this program, you can defer capital gains for up to 20 years, which is really helpful if you can invest money for 20 years, you can imagine how that decreases, the funds that you make decreases, how much you or helps to pay that capital gain at the time you do take it. The other thing is you have the advantage of inflation. So, if you looked at inflation at 2%, over 20 years, you're actually paying the tax with 67 cents on the dollar. Inflation is to your advantage by using this.

The other thing about this tool is many people that sell a business, or sell a rental property, you're looking for income. And if you sell that property using this tool, you can actually replace that or continue that income. So, it's got some good features there. So, you could take 5% out each year and continue to get your income stream over that 20 years, and still defer the bulk of the capital gains.

One last item is that it protects the assets against creditors and lawsuits. So, a lot of times when you think about selling a property or selling a business, or you can use it to sell artwork, you can use it to sell many things. But when you sell an item, if you give the person you sold it to a loan, sometimes you're not sure if they'll keep the business running profitably, or sometimes the value of the real estate may change. Because of the real estate market, the value may be up. If you give them a loan, and then later on that buyer says, “Well, I'm going to walk away from the sale,” or “I think I can do better not selling it,” this tool protects you because you're selling it fully, you're deferring the capital gains, and you're using a trust to hold it.

So, I'm going to keep trucking, a lot of people that sell real estate, they're dependent on the income from one asset. The other thing that this does is it diversifies your assets and you can invest in other things in this trust. So, you're not limited to just one type of asset that you're investing in.

Again, the tool is called an intermediated instalment sale. It really is a simple concept. One of the things that you need to know for sure is that before you use it, you can't have signed an agreement with someone. It's very similar to a 1031, where — if you've already signed a document or come to an agreement with the buyer, then that takes away that option of the 1031. So, the intermediated sale has that same requirement that you have to set this up before you actually make the sale. The question is when do you want to pay the tax? Whether do you want to pay it in the current year or do you want to pay it over 20 years, and we think there's lots of advantages to waiting and selling over the 20 years.

So, first you have your property, and you're going to sell it. This is the instalment sale. So again, no cash changes hands, you sign a promissory note, you don't have to pay tax until the cash is received. So, that same concept works with this instalment sale. What we're doing with this section 453 is we're going to set up a trust and we're going to set up the trust in Nevada, where there's no state income tax, so that's another advantage to doing it by setting up the trust in that location.

So, just like the instalment sale, you have an agreement to sell. But before you do it, you're going to set up a trust between the buyer and the seller. Let's say for example, you're going to sell for $5 million. What you do is you set up a trust, and we are using Dunham Trust Company, and the trust actually steps in and they make the sale. So, you're going to transfer your asset to the trust. The trust makes the sale, and they hold that gain in the trust and you don't have to pay tax then until you receive the cash. This is an irrevocable trust, so you're putting it inside the trust to hold the capital gains until you receive it.

The irrevocable trust is set up for the benefit of the seller, so the funds that go in the property is transferred to the trust at the beginning and it's irrevocable, and then the trust actually does the sale and holds the capital gains inside that truss. So, it defers the capital gains until you actually receive the cash and you can then take out a 5% income stream or some other type of income stream. If you don't need the income, you can hold off and take it in different payments over time, and Dunham Trust or whatever trust company you would use helps determine how that works. I do have kind of a hypothetical case that I would talk through.

[0:10:56.0] WS: I mean, it sounds like you have control over that trust, though, right? I mean, you have control over the trust, if the 5 million is sitting in there, say I started a trust, I transfer the property to that trust, and then we sell it or the trust sells it, then that 5 million goes into the trust. And then I'm in charge of managing that capital. It’s almost like a self-directed IRA at that point or traditional IRA, it sounds like. Potentially, it is going to be taxed, but I can control it. I can say I want to put 50,000 in this deal then and 50,000 in that deal or if I was a passive, if I wanted to go passive, become a passive investor, and then I assume any gains that you're then gaining off that money is going to go right back into that trust.

[0:11:39.0] KD: It does. And you aren't paying any tax on those gains — they sit in that trust until they're distributed. So, you are in control of when the money comes out and benefits the seller.

[0:11:54.0] WS: What happens if you die?

[0:11:57.1] KD: It goes to your heirs. And just like any other trust you name, who would receive those funds, and they can actually leave the trusts in place and continue the income. So, it gives your heirs some options as well.

[0:12:13.8] WS: Would they then have to pay capital gains?

[0:12:15.8] KD: They would if they took the funds out of the trust. If they leave the funds in the trust, again, it's a tax play for your heirs that they can kind of control when that money comes out of the trust to pay the tax as well.

[0:12:33.1] WS: Okay, so for example, or a different example there, if I'm close to let's say, I've 95. But still, I own this large commercial building, it may be better for me to hold that property until I die, and then maybe let my heirs put it in a trust or something like that afterwards, if they could assume at the current rate, does that make sense? So, they're not paying capital gains and then do this?

[0:12:54.7] KD: My question is, are you saying that they shouldn't set up the trust until after the –

[0:13:01.3] WS: Until after I die. I wonder your opinion, just so that way, if I bought it for three million, and now it's worth five, if I sold it today, I'm going to have to pay capital gains on that two million. But if they inherited it, they could inherit it at the current value.

[0:13:16.1] KD: Yes, absolutely. Of course, Congress, that is one of the issues on the table is whether or not they're going to take away that step-up basis, or step up in basis. So, this might become more advantageous if they do something like that, and take away that step-up basis, you might want to hurry up and put it in the trust so that you can transfer it.

[0:13:41.6] WS: Okay. Give us this case study quickly, while we have a few more minutes, I want to learn a little more about it. And so, the listener can also just think through this case study, and maybe it will work for them.

[0:13:52.1] KD: Okay, so the assumptions are it's a California asset. So, they're going to be paying both Federal and California state capital gains tax. We're assuming you own 100% of the asset, it's valued at five million and the cost basis is 500,000, which is not unusual for some real estate or some asset where you find that kind of gain on the asset. And then there's no debt on the asset. So, those are the assumptions that we're talking about with this particular case study or this hypothetical.

If you look at it, the other, I guess the thing we were going to talk about is that the capital gains rate would be at 20% for the Federal which is the highest rate currently. And then the state capital gains for California is 13.3% at the highest level. And with capital gains, most of you know you have to also pay the Medicare tax rate of 3.8%. So, we’re not including any local tax. Those are the assumptions with the case. The taxes due at the time of the sale would be 900,000. So, that's taking that gain of 4.5 and applying the Federal and the state capital gains tax. The state capital gains would be 598,000. And the Medicare tax would be 171,000. So, the total tax due, if you are just going to sell outright, pay the tax in the current year would be 1,669,500 of that $5 million sale. The net after taxes, if you compare the 5 million versus the 1.6, the net after taxes is 3.3 million. That's what you would receive after you've paid your taxes.

If you were to just compare this to an intermediated instalment sale, you're showing that 3.3 million, if we would use the trust, you would have 4.9 million, because you're putting the 5 million inside the trust, and you're not paying taxes until you distribute it. So, let's say the 5 million sale then goes inside that trust, you're going to get a 6% rate of return on that. So, you have 4.9 million to invest and earn versus an outright sale of 3.3. And that's where the advantage comes.

If you were going to get an annual return of 6% on those funds, you'd have 199,000 on outright sale, versus 271,000 on the intermediated sale. So, this assumes that you're paying 1.25 for the on-boarding costs, and you're getting 5.5% for the trust administration fee. So, there are costs associated with setting up the tool and those have been subtracted from the cash that you would have to invest. And then if you look at the income over 20 years, the outright sale has 3.9 of income that you could have versus 5.4 million that you could have using the intermediate instalment sale.

So, the tax due after 20 years, you do have to pay the tax on the intermediated sale, it doesn't take it away. It just differs it. The total economic advantage of doing the intermediated sale is 1.3 million of what you earned by having the higher cash value to invest during those 20 years.

[0:18:20.6] WS: What about the taxes that you would pay on the gain, that you gained over those 20 years, that 5.4 million there? Is that included in that 1.6 million in taxes?

[0:18:31.1] KD: It is netted. So, it's showing this annual return net of that taxes.

[0:18:38.3] WS: Interesting.

[0:18:39.5] KD: Just showing that you're paying, if you look at it, with 2% inflation, you're paying 67 cents on the dollar. So, using inflation to your advantage.

[0:18:53.4] WS: Awesome, Kim, I know a couple things you mentioned there, I thought you could just highlight — why somebody would do this versus doing a 1031?

[0:19:01.0] KD: Well, with a 1031, you have a risk of the real estate market impacting the value of that new property or the value or the risk of not being able to get your income stream from that new property. We have worked with some clients that have done 1031 and they've bought another property, but then couldn't rent the property. So, sometimes it works out just fine and we think it's a perfectly good solution to paying tax. We actually have clients that have done the 1031 and they work out fine. But depending on the real estate cycle, there's no doubt that somebody can buy another property thinking they're going to rent income, or get rent income from that property. And they aren't able to get it rented and that's painful to see somebody who sold the property still needing the income stream in their retirement days, and they can't get the income.

In this solution, those assets are liquid. So, you're investing and diversifying in lots of different sections of the market and it's liquid you can get at those funds. And you decide when you need it. If for example, you're taking a 5% income, and you then maybe need money for a new car in your retirement or something, you can do a distribution for that one-time distribution, you just know you have to pay the tax on it, when you take it.

[0:20:42.7] WS: I can see it being just very attractive to a lot of investors, but just for what you just said, I mean, it's more liquid, I can access it. If I need to pay myself, I can. If I need some money, I can do a distribution. And I can take that 5 million and put it across 20 different investments, as opposed to one more deal or something like that. And then just the timing stresses of the 1031 exchange.

Kim, unfortunately, we are out of time. But just a great option that you brought to this today that I feel like it's going to be brand new to most of the listeners. I don't think I've heard of it before personally. And so, this is good stuff. But a couple of quick questions. What's the number one thing, Kim, that that has contributed to your success?

[0:21:24.1] KD: I think trying to use tools that are available in the code and being conscious of what the taxes are, it's so critical. I probably run into a lot of people that think they've got an asset. They think they're set for their retirement. And the real estate market goes through a cycle and impacts their retirement. So, I think being conscious of what's going on in around you and using the tools that are available.

[0:21:54.6] WS: And how do you like to give back?

[0:21:56.4] KD: I'm involved in scholarship programs, and we like to raise funds for scholarships to help put kids through financial or whatever career they're in. So, that's a big part of what we work on is trying to open doors for young people to get into careers that they're interested in.

[0:22:21.7] WS: Kim, it's been a pleasure to get to meet you and learn about this tool. I mean, I just think it's something all the listeners should have in their tool belt or in their arsenal things that, “Hey, this may be a great option for you.” And I would imagine if you're contemplating or thinking that maybe it is, I'm sure Kim would be a great resource for you to know so she can help you walk through thinking about that property you're fixing to sail. Maybe you were thinking about doing 1031 and maybe this could be a better option. So, Kim, how can the listeners get in touch with you and learn more about you?

[0:22:51.6] KD: You can contact me at team@keystonegroupaz.com. Or you can call at (623) 299-9710 and we've got a great spreadsheet that would just put in your sale price and your costs and run through a calculation to show what you might save by doing this. It calculates the capital gains and it shows you what the savings or what the advantage of doing the tool might be. So, we'd be glad to run that spreadsheet for you and give you an idea of how the tool would impact you. Thank you very much for the opportunity. We hope you got a few nuggets out today.

[END OF INTERVIEW]

[0:23:41.3] WS: Don't go yet, thank you for listening to today's episode. I would love it if you would go to iTunes right now and leave a rating and written review. I want to hear your feedback. It makes a big difference in getting the podcast out there. You can also go to the Real Estate Syndication Show on Facebook so you can connect with me and we can also receive feedback and your questions there that you want me to answer on the show.

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[OUTRO]

[0:24:21.7] ANNOUNCER: Thank you for listening to The Real Estate Syndication Show, brought to you by Life Bridge Capital. Life Bridge Capital works with investors nationwide to invest in real estate while also donating 50% of its profits to assist parents who are committing to adoption. Life Bridge Capital, making a difference one investor and one child at a time. Connect online at www.LifeBridgeCapital.com for free material and videos to further your success.

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