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Trapped by Your Real Estate Investment?

Enter the syndicated real estate investment vehicle

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Trapped by Your Real Estate Investment?

High net worth individuals have long benefited from real estate's positive investing attributes: hard assets v. volatile securities, income producing qualities, inflation hedges, and favorable tax benefits. But direct ownership of those assets frequently leads to feelings of being trapped. Trapped by a high maintenance property which consumes time, cost, and energy; Trapped economically by rental/income appreciation and fully depreciated tax shields which result in high taxable real estate income.

Enter the syndicated real estate investment vehicle. With proven operators, and the favorable treatment of cost segregation, investors seeking to be Liberated from their prior investments in real estate or obtain better after tax returns can leverage the benefits of syndicated real estate investments through 1031 exchange, refinance/reinvestment, or asset reallocation to capture depreciation tax shields.





Professionals

For CPAs looking to ease their client's tax burden, Centura Wealth Advisory's alternative investment offering provides compelling solutions to real estate tax problems. Our team at Centura routinely identifies and develops strategies for real estate consolidation, optimization, and rebalancing to allow for enhanced yield, improved tax efficiency and a steady deal flow which allows for diversification and laddering.

Benefits of Centura's solution include:

- Passive income offsets with accelerated depreciation
- Due diligence on proven operators who successfully utilize cost segregation
- Frequent access to deals
- Individual LP ownership with institutional level oversight, reporting, and investor benefits

Individual Investors

Investors looking for diversification, better after-tax yields, and supplemental income should consider Centura's alternative investment platform to provide access to high quality passive real estate investments. These investments allow for direct ownership of alternative assets and institutional benefits, but require investors to meet the following criteria:

- Accredited Investor Status
- Non-Qualified funds
- Long time horizon (i.e., 10+ years)

Benefits of Centura's solution include:

1. Looking to rebalance or enhance their asset portfolio to minimize tax implications
2. Seeking low volatility income producing real estate investments
3. Burdened by passive income sources due to exhausted depreciation



Introduction

The goal of building wealth is linked inextricably to tax management. This paper explores tax advantages associated with passive real estate investments from depreciation and 1031 exchange.

To frame our discussion:

- “Gross” investment returns are measured before considering the impact of both ordinary income and capital gains taxes on a specific investment strategy.
- “Net” investment returns measure performance after taxes.
- “Tax drag” is the difference between these two metrics.

For equity investments, tax drag has been estimated at 1-2% per year¹ whereas income producing assets (taxable bonds, real estate, etc.) are taxed at the highest rates² (depending on how they are structured), resulting in higher tax drag. Thus, targeting ordinary income producing investments that are structured to mitigate income tax is critical to maximizing net returns for tax savvy investors/advisors.

At Centura Wealth Advisory (CWA) we utilize tax advantaged investment solutions such as passive real estate, held in advantageous legal structures, to minimize tax drag and reduce portfolio risk. Understanding the subtle tax related nuances of these investments is the key to unlocking their immense value and this paper highlights such tax code intricacies.



Passive Real Estate Investments

What Are They?

A passive real estate investment is one in which money is invested with a professional owner/operator who purchases, improves, maintains, leases and administers real estate properties to generate income on behalf of investors.

Passive real estate investments are common among sophisticated investors looking to generate tax advantaged income while maintaining exposure to an appreciable asset that is inflation resistant and economically resilient. While investor accreditation may be required, passive real estate investments are often held in combination with other traditional investments (stocks and bonds) to achieve portfolio diversification through the risk reducing properties of the alternative asset class.

Key considerations of these dynamic, multi-faceted investment vehicles include:

- Barriers to entry (e.g., required accreditation, access to deals, other)
- Unique risk/return attributes – non-correlated with traditional assets like stocks and bonds
- Reliable/predictable income
- Tax advantages – (covered in next section)
 - Depreciation
 - Qualified 1031 exchanges

Furthermore, they are illiquid and the transaction market for properties is inefficient, creating replicable advantages for experienced owner/operators in the space. Thus, such investments often play a central role in High Net Worth portfolios and are a key tenet to tax planning, portfolio planning and investment management at Centura.



Tax Advantages of Passive Real Estate Investments

There are two aspects of passive real estate investments that make them unique tax advantaged investment vehicles: depreciation and 1031 exchange. While both active and passive real estate investors stand to benefit from both, what makes some passive syndicated offerings unique is their ability to leverage cost segregation to accelerate depreciation and bring forward tax benefits that would otherwise be deferred³.

When choosing passive investments, however, it is critical to select a best-in-class operator with the following considerations:

- Track record
- Co-Investment
- Vertical integration
- Strong management team
- Product and geography experience
- Well capitalized
- Industry relationships – lender, broker, principle
- Deep knowledge of accelerated depreciation & cost segregation

Tax exempt investors should be aware that passive real estate investments use debt to acquire property which can result in taxable income to some organizations not otherwise subject to taxation. This income is known as Unrelated Business Taxable Income (UBTI) and is generally similar to the taxable income or loss of the property.

Depreciation

The first key to liberating wealth through passive real estate investing is depreciation, which allows investors to defer tax on income. Depreciation is an accounting concept that describes assets' expected decline in value over time. Essentially all items (buildings, land improvements, furniture & fixtures, etc.) except for land can be depreciated for tax purposes. Tax laws allow investors to take a deduction for property depreciation which offsets taxable income. This depreciation then reduces the tax basis of the asset, resulting in a deferral of the tax until the property is sold.

In the landmark case of *Hospital Corporation of America v. Commissioner*³, it was concluded that the timing of depreciation for certain assets would be expanded, allowing for the accelerated method of utilizing 5, 7 or 15-year rates of depreciation. Without cost segregation, these assets would have been subject to a 39 or 27.5 year depreciation schedule, resulting in a much higher short term tax liability.

In research conducted by Centura Wealth Advisory and our partners, we have found that multi-family real estate offers unique advantages in cost segregation (compared to other passive real estate investments) due to the inherent nature of low land to improvement ratios. This favorable accounting and economic backdrop allows investors to purchase an asset that creates passive real estate income, shielded from taxation for a significant number of years; in many cases. Such an investment is highly accretive to wealth, and outside of passive real estate investing does not exist.

**Multi-family real estate
offers significant
advantages with Cost
Segregation**

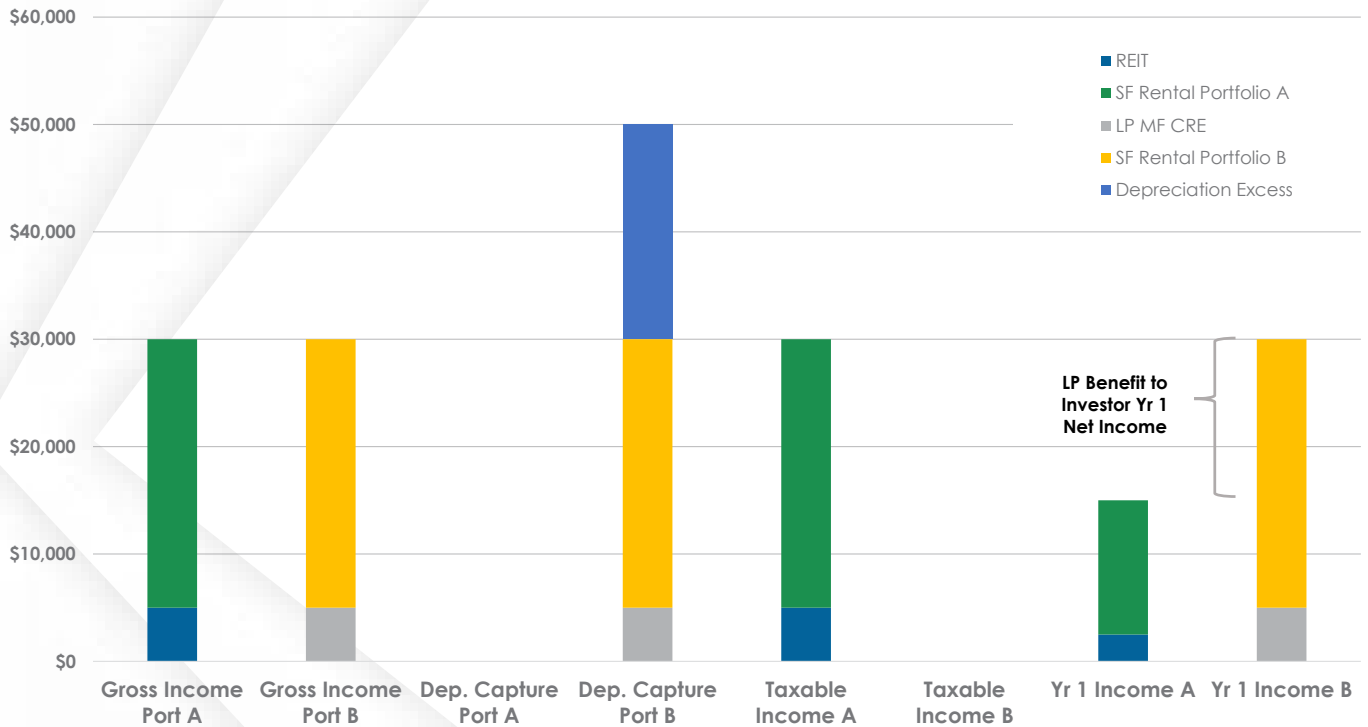
Hypothetical Example - Depreciation

To demonstrate the potential benefits of accelerated depreciation, consider the following example:

- Client has \$100,000 available to invest in an income producing asset (e.g., REIT, LP)
- Client also owns a \$500,000 passive real estate investment (i.e., existing Single Family [SF] rental)
- Centura Wealth Advisory has access to the following passive real estate investment: a new money allocation for a private placement, limited partnership investment for \$100,000 per share
 - Cash on cash distributions at a target average annual rate of 7.2% over a 10-year period
 - Starting distributions at 5% annual rate
 - \$100,000 equity investment (one share) acquires \$102,000 in depreciation over 10 years
 - \$50,000 available to use in Year 1

If this client were to purchase one share of this investment for \$100,000, they would immediately be able to utilize the first-year depreciation to shield all \$25,000 passthrough income resulting in no current year tax liability associated with this income. In addition, the unused depreciation would remain in place as a tax asset for the client and can be used to offset future passthrough real estate income. Effectively, depreciation would limit the passthrough income making it to page 1 of the 1040 (tax return) and thus exclude it from taxation in the current year.

Real Estate Portfolio - Leveraging LP Depreciation



Assumptions:

1. Excess depreciation from LP investment is applied to SF rental income as a current year tax shield
2. Depreciation not utilized in year 1 is carried forward to the next year and available for use against future passive real estate income
3. Estimated effective tax rate (Federal & State) is 50%

An investment of \$100,000 may not be material from the perspective of portfolio diversification, nor is it a permanent solution to shielding passthrough income. To better meet those objectives, investors can create multiple tranches of passive real estate investments of this nature over time, generating a bank of depreciation (tax assets) that can be used to shield passthrough real estate income for years to come.

This strategy also allows investors to build a geographically diverse passive real estate portfolio that is comprised of investments from different vintages. When done properly, this approach can potentially lower portfolio risk, enhance risk adjusted returns, and make your portfolio more stable and sustainable.

Hypothetical Example - 1031 Exchange

While depreciation allows you to defer taxes today, it does so at the expense of realizing taxes in the future (at the time of sale) through what is known as depreciation recapture. If at the time of sale, a property is worth more than its depreciated value, the cumulative depreciation is taxed as ordinary income (at the highest rate(s)).

However, unlike with stocks or bonds, real estate investments possess a unique benefit allowing this gain to be deferred even farther into the future. Under U.S. Internal Revenue Code Section 1031⁴ real estate investments may be exchanged into like-kind property of equal or greater value within a specified time period through what is commonly known as a 1031 exchange.

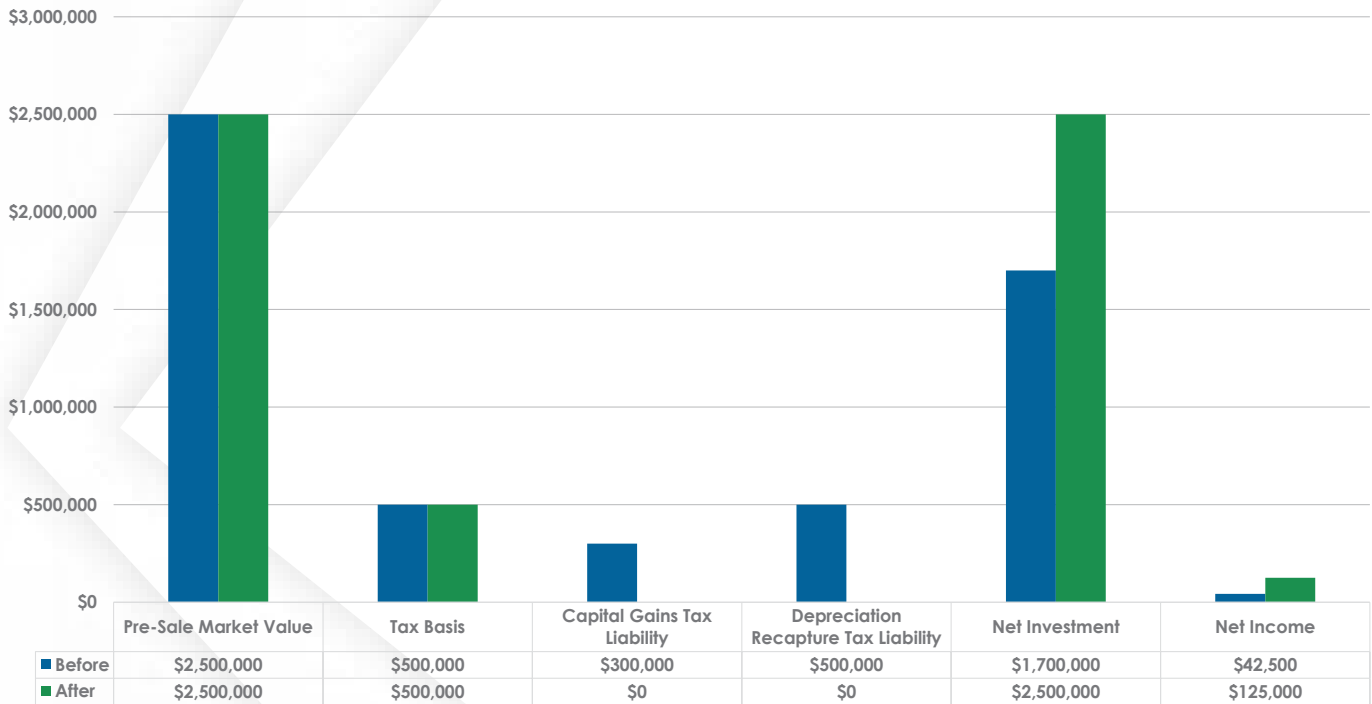
This type of exchange is the second liberating aspect of passive real estate investing and allows real estate investors to avoid depreciation recapture and capital gains by investing all proceeds from the real estate disposition into the acquisition of a new property (like kind) within 180 days. If executed properly, a 1031 exchange defers tax liabilities associated with depreciation recapture (income) and capital gains (appreciation).

Consider the following example, where a Centura Wealth Advisory client owns property that was acquired 20 years ago and is currently being sold.

- Gross proceeds from sale: \$2,500,000
- Adjusted Tax Basis: \$500,000
- Potential gain exposure: \$1,000,000
- Depreciation recapture exposure[^]: \$1,000,000

[^] includes excess depreciation recapture

Merits of 1031 Exchange v. Sale



Assumptions:

1. Estimated effective capital gains tax rate (Federal + State) is 30%
2. Estimated effective ordinary income tax rate (Federal + State) is 50%
3. Net investment proceeds in the "Before" scenario are assumed to be reinvested in a taxable REIT yielding 5%
4. Net investment proceeds in the "After" scenario are assumed to be reinvested in a tax advantaged LP yielding 5%
5. Net Income is on a go forward basis

In order to avoid paying taxes on depreciation recapture and capital gains of \$1,000,000, this client could enter a 1031 exchange and purchase a new \$2,500,000 passive real estate investment through Centura Wealth Advisory. A properly executed 1031 transaction could save this client \$800,000 in taxes in addition to providing them with a new investment that will generate nontaxable income/cashflow based on the full asset value of \$2,500,000. This income delta equates to an additional \$82,500 per year (at 5% starting distribution) and is 2.94x higher (per year) as compared to the "do nothing scenario" where net proceeds are assumed to be invested in a taxable income producing asset yielding 5% (e.g., REIT).

Conclusion



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The passive approach to real estate investing is materially different than active real estate investing and is not the norm for many real estate investors. Active real estate investors are responsible for improvements, maintenance and leasing, all of which can be an extreme headache. In addition, many long-time real estate investors have exhausted their depreciation allowance and are now facing taxable income as well depreciation recapture if they were to sell. Investors such as these have become burdened by their wealth and often don't know what to do or where to go for help; they simply stay invested and keep paying taxes. At Centura, we regularly work with existing real estate investors – and their roster of professionals (CPAs, Attorneys, Estate Planners) - who find our passive real estate solutions to be liberating in both their personal and financial lives.

References

¹Lipper Analytics 2010 Tax Study ; Peterson, J.D. et al (2002) Explaining After-Tax Mutual Fund Performance, Financial Analysts Journal, Vol. 58, no 1,; Longmeier, G. and G. Wotherspoon (2006) The Value of Tax Efficient Investments: An Analysis of After-Tax Mutual Fund and Index Returns. Journal of Wealth Management

²IRS 1040 2019 Tax Rates <https://www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2019>

³Hospital Corporation of America v. Commissioner. Docket Nos. 10663-91, 13074-91, 28588-91, 6351-92, 74 T.C.M. 1020 (1997) T.C. Memo. 1997-482. United States Tax Court. October 27, 1997; Engineered Tax Services. (2019) The History of Cost Segregation

⁴Cornell Law School (2019) 26 U.S. Internal Revenue Code, Section 1031: Exchange of real property held for productive use or investment. <https://www.law.cornell.edu/uscode/text/26/1031>

Centura Wealth Advisory is an SEC registered investment adviser located in San Diego, California. This brochure is limited to the dissemination of general information pertaining to Centura's investment advisory services. Investing involves risk, including risk of loss.

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For additional information about Centura, please request our disclosure brochure as set forth on Form ADV using the contact information set forth herein, or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). Please read the disclosure statement carefully before you engage our firm for advisory services.