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TAX-ADVANTAGED INVESTMENT SOLUTIONS

This packet is designed to serve the needs of clients who are 1) facing taxes on capital gains or 2) planning to make an investment (or reinvestment) into real estate. This packet presents a relatively comprehensive set of solutions to provide clients with a broad grasp of their needs and the best strategies available to address those needs. The specific sections and separate articles provide details for clients to understand how each strategy and concept would apply to their particular situation.

PART 1 – CAPITAL GAINS TAX SOLUTIONS

Part 1 of this packet is designed to provide investors with the primary solutions to mitigate or eliminate their capital gains taxes. This section applies to investors who are facing any capital gain tax situation—including the sale of property or a business, the maturity of the principal on a note, a large sale of stock, or debt forgiveness. Part 1 focuses on tax-sheltering strategies that both do and do not involve real estate—all sanctioned by IRS guidelines. Part 1 serves the needs of investors with a significant capital gains tax exposure—regardless of the origin of their gain. Please see the table of contents as well as the introduction to Part 1 on page 2 for a detailed breakdown of this section's contents.

PART 2 – REAL ESTATE INVESTMENT SOLUTIONS

Part 2 of this packet is devoted entirely to the fundamentals of real estate ownership and investment—regardless of tax motivation. Whether investors are looking for current tax deferral through real estate or is simply diversifying a portion of their portfolio into investment property, Part 2 provides essential due diligence information for real estate investors. Part 2 of this packet is intended to serve the needs of any investor who is making a real estate investment—whether a first purchase or a reinvestment to complete an exchange. Please see the table of contents as well as the introduction to Part 2 on page 20 for a detailed breakdown of this section's contents.

QUESTIONS?

If you have any questions related to this guide, or if you would like more information on a topic that is not included in this guide, please contact us! We have articles and resources that cover a wide range of topics beyond those covered in this packet. We would be happy to help. If your question is outside our expertise, we can refer you to other professionals who specialize in your particular area of need. Our email is info@jrwinvestments.com and our phone number is (877) 579-1031.

PART 1:

Capital Gains Tax Solutions

CAPITAL GAINS TAX SOLUTIONS SUMMARY

This section serves the needs of investors who face any capital gain tax situation—regardless of whether it is the result of the sale of property or a business, the maturity of the principal on a note, a large sale of stock, or even certain debt forgiveness situations.

CAPITAL GAINS TAX WORKSHEET AND EXAMPLE (PAGES 6-7):

This worksheet allows an investor to calculate their potential capital gains taxes on a particular transaction—whether real estate or otherwise. This worksheet is available on MS Excel, and we would be happy to provide you with an electronic copy upon request. Please email info@jrwinvestments.com or call (877) 579-1031

1031 EXCHANGE (PAGES 8-10):

This tax-deferral strategy applies to investors who have sold or are about to sell investment real estate. This strategy allows a client to defer paying taxes on all sales proceeds that are reinvested into other investment real estate as long as they 1) do not take constructive receipt of the funds within the exchange transaction and 2) meet all of the guidelines outlined by the IRS.

721 EXCHANGE (PAGES 11-12):

This tax-deferral strategy applies to investors who have sold or are about to sell investment real estate. This strategy is similar to the 1031 exchange but allows an investor to exchange his property for an interest in a diversified portfolio of real estate called a “Real Estate Investment Trust (REIT)”. As with the 1031, the client must not take constructive receipt of the sales proceeds within the transaction.

INTRODUCTION TO TAX WRITE-OFFS AND CREDITS (PAGE 13):

Like the Installment Contract tax write-off and credit strategies can provide solutions to a multitude of capital gains tax issues beyond real estate. These types of strategies can be applied even against ordinary income or the alternative minimum tax. Unlike the 1031 or 721 exchanges or even the Installment Contract, a client can take constructive receipt of the sales proceeds and still implement an effective tax shelter. Moreover, as the name suggests, clients are able to write off or cancel their tax exposure with these types of investments, rather than only defer the exposure (as with the other strategies).

INTRODUCTION TO THE 1033 EXCHANGE (PAGES 14-15):

This tax-deferral strategy applies to investors who face involuntary conversion or sale of their property (typically related to eminent domain or destruction by natural disaster). This strategy allows an investor to avoid paying taxes on all conversion proceeds received as long as those funds are reinvested in “like-kind” real estate within the timeframe given. The investor can take constructive receipt of the funds and has a longer timeframe to make the reinvestment.

CAPITAL GAINS TAX WORKSHEET

This worksheet can provide an approximate estimate of your capital gains tax exposure on the sale of your asset. However, this is only an estimate and does not take into account all of your other potential tax considerations that could impact your total tax liability. You should consult a CPA for a more comprehensive review of your tax situation to ensure an accurate estimate of your tax liability.

	Sales Proceeds		
1	Total Sales Price (Including Debt):		
2	Total Sales Cost:		Includes selling commissions, costs of inspections, escrow, etc.
3	**Total Sales Proceeds w/Debt:**		**Subtract Line 2 from Line 1.**
	Basis		
4	Original Purchase Price:		If property was inherited, use value of step up in basis for Line 4.
5	Depreciation Utilized:		Any depreciation used to shelter cash flow during your hold period?
6	**Purchase Price Basis:**		**Add Lines 4 and 5 together.**
7	Capital Improvements:		Include funds used towards capital improvements of your investment.
8	**Total Estimated Basis:**		Add Lines 6 and 7 together.
	Capital Gains		
9	Total Sales Proceeds w/Debt:		Copy total from Line 3.
10	Total Estimated Basis:		Copy total from Line 8.
11	**Total Estimated Capital Gains**:		**Subtract Line 10 from Line 9.**
	Estimated Capital Gains Taxes		
12	Total Estimated Capital Gains:		Copy total from Line 11.
13	Fed Capital Gains + Medicare Tax:		Federal Long-Term Capital Gains Tax is currently 20% and Medicare Tax is 3.8%.
14	**Fed Capital Gains + Medicare Taxes:**		**Multiply Lines 12 and 13.**
16	Depreciation Subject to Recapture Tax:		**Copy total from Line 5.**
17	Depreciation Recapture Surcharge:		**Capital Gains for Depreciation Recapture is 25% (5% over LT capital gains rate.)**
18	**Total Depreciation Recapture Surcharge:**		**Multiply Lines 16 and 17.**
19	Total Estimated Capital Gains:		Copy total from Line 11.
20	State Income Tax on Capital Gains:		CA: 11.3% on income of $47,056+ (Out of state: your tax will vary!)
21	**State Capital Gains Income Tax:**		**Multiply Lines 15 and 16.**
22	Fed Capital Gains + Medicare Taxes:		Copy total from Line 14.
23	Depreciation Recapture Surcharge:		
24	State Capital Gains Income Tax:		Copy total from Line 17.
25	**Total Estimated Capital Gains Tax:**		**Add Lines 18 and 19.**
	Estimated After-Tax Equity		
26	Total Sales Proceeds w/Debt:		Copy total from Line 3.
27	Debt on Relinquished Investment:		Include total debt/liabilities on relinquished investment.
28	**Gross Equity Proceeds from Sale:**		**Subtract Line 22 from Line 21.**
29	Gross Equity Proceeds from Sale:		Copy total from Line 23.
30	Total Estimated Capital Gains Tax:		Copy total from Line 20.
31	**Net Equity Proceeds From Sale:**		**Subtract Line 25 from Line 24.**

CAPITAL GAINS TAX WORKSHEET (EXAMPLE)

This worksheet can provide an approximate estimate of your capital gains tax exposure on the sale of your asset. However, this is only an estimate and does not take into account all of your other potential tax considerations that could impact your total tax liability. You should consult a CPA for a more comprehensive review of your tax situation to ensure an accurate estimate of your tax liability.

	Sales Proceeds		
1	Total Sales Price (Including Debt):	$40,000	
2	Total Sales Cost:	$32,000	Includes selling commissions, costs of inspections, escrow, etc.
3	**Total Sales Proceeds w/Debt:**	$368,000	**Subtract Line 2 from Line 1.**
	Basis		
4	Original Purchase Price:	$15,000	If property was inherited, use value of step up in basis for Line 4.
5	Depreciation Utilized:	$5,000	Any depreciation used to shelter cash flow during your hold period?
6	**Purchase Price Basis:**	$10,000	**Add Lines 4 and 5 together.**
7	Capital Improvements:	$50,000	Include funds used towards capital improvements of your investment.
8	**Total Estimated Basis:**	$60,000	Add Lines 6 and 7 together.
	Capital Gains		
9	Total Sales Proceeds w/Debt:	$368,000	Copy total from Line 3.
10	Total Estimated Basis:	$60,000	Copy total from Line 8.
11	**Total Estimated Capital Gains**:	$308,000	**Subtract Line 10 from Line 9.**
	Estimated Capital Gains Taxes		
12	Total Estimated Capital Gains:	$308,000	Copy total from Line 11.
13	Fed Capital Gains + Medicare Tax:	23.80%	Federal Long-Term Capital Gains Tax is currently 20% and Medicare Tax is 3.8%.
14	**Fed Capital Gains + Medicare Taxes:**	$73,000	**Multiply Lines 12 and 13.**
16	Depreciation Subject to Recapture Tax:	$5,000	**Copy total from Line 5.**
17	Depreciation Recapture Surcharge:	5.00%	**Capital Gains for Depreciation Recapture is 25% (5% over LT capital gains rate.)**
18	**Total Depreciation Recapture Surcharge:**	$250	**Multiply Lines 16 and 17.**
19	Total Estimated Capital Gains:	$308,000	Copy total from Line 11.
20	State Income Tax on Capital Gains:	11.3%	CA: 11.3% on income of $47,056+ (Out of state: your tax will vary!)
21	**State Capital Gains Income Tax:**	$34,804	**Multiply Lines 15 and 16.**
22	Fed Capital Gains + Medicare Taxes:	$73,304	Copy total from Line 14.
23	Depreciation Recapture Surcharge:	$250	
24	State Capital Gains Income Tax:	$34,804	Copy total from Line 17.
25	**Total Estimated Capital Gains Tax:**		**Add Lines 18 and 19.**
	Estimated After-Tax Equity		
26	Total Sales Proceeds w/Debt:	$368,000	Copy total from Line 3.
27	Debt on Relinquished Investment:	$100,000	Include total debt/liabilities on relinquished investment.
28	**Gross Equity Proceeds from Sale:**	$268,000	**Subtract Line 22 from Line 21.**
29	Gross Equity Proceeds from Sale:	$268,000	Copy total from Line 23.
30	Total Estimated Capital Gains Tax:	$108,000	Copy total from Line 20.
31	**Net Equity Proceeds From Sale:**	$159,0642	**Subtract Line 25 from Line 24.**

INTRODUCTION TO THE 1031 EXCHANGE

Investors preparing for the sale of a property held for business or investment purposes may want to consider a 1031 exchange. Section 1031 of the Internal Revenue Code allows real estate investors to defer costly capital gains and recapture taxes by reinvesting in like-kind real estate. Utilized properly, 1031 exchanges provide investors with substantial tax deferral that allow them to shelter the growth of their wealth and keep more of their money working for them.

In a typical property sale, the seller must pay taxes on the capital gains realized as well as on the prior depreciation that was utilized to defer taxes on the property's income. These capital gains and depreciation recapture taxes can exceed 20–30% of the gains realized upon sale. If a 1031 exchange is utilized, the burden of capital gains and depreciation recapture taxes can be deferred, allowing an investor to potentially build wealth through income and appreciation on reinvested capital that otherwise would have been lost to taxes.

GUIDELINES TO QUALIFY FOR A 1031 EXCHANGE

The IRS outlines several rules that must be followed for a transaction to qualify for tax deferral through a 1031 exchange. Rules address which types of real estate can be utilized for an exchange, how proceeds from the sale of the relinquished property must be handled throughout the exchange, how and when replacement property must be identified, and required timelines for closing on the replacement property.

There are three essential rules of a 1031 exchange: 1) The investment properties exchanged must be the same in nature and character. 2) The value of the replacement property must be equal to or greater than the value of the relinquished property to obtain a full deferral. 3) The title of ownership on the replacement property must be the same as on the relinquished property.

WHICH PROPERTIES QUALIFY FOR A 1031 EXCHANGE?

According to IRS section §1031, both the relinquished and the replacement properties must be held for investment purposes, and they must be "like-kind" properties. Property held for investment purposes can include a multitude of real estate types, but most are rental properties or commercial real estate. Personal residences and vacation homes that are not utilized primarily as rentals do not qualify for a 1031 exchange. "Like-kind" simply refers to the fact that investment real estate must be exchanged for investment real estate. In other words, investment real estate cannot be exchanged for stock, debt, or other investments in a 1031 exchange. Also, a 1031 exchange applies only to real estate located in the United States.

UTILIZING A QUALIFIED INTERMEDIARY (QI)

If an investor takes constructive receipt of the proceeds (cash) from the sale of the relinquished property, a 1031 exchange cannot occur. The Treasury provides safe harbor guidelines that allow an investor to use a Qualified Intermediary (QI) to avoid taking constructive receipt of the funds in an exchange transaction. A QI is any independent party that facilitates tax-deferred 1031 exchanges in accordance with IRS section 1031. The QI utilizes the funds from the sale of the relinquished property to purchase the replacement property. The QI must be independent and cannot be the investor, relatives of the investor, or any person deemed to be under direct control of the investor.

REPLACEMENT PROPERTY IDENTIFICATION GUIDELINES

The IRS outlines three ways that replacement property can be identified: the 3-Property Rule, the 200% Rule, and the 95% Rule.

3-Property Rule: Allows an investor to identify up to three potential replacement properties and close on any or all of them to complete the exchange.

200% Rule: Allows any number of properties to be identified as long as their total value does not exceed twice the value of the relinquished property. As in the case of the 3- Property Rule, once identified, any or all of the potential replacement properties can be purchased to complete the exchange.

95% Rule: Allows an investor to identify an unlimited number of properties, but the investor must purchase 95% of the aggregate fair market value of all of the properties identified.

1031 EXCHANGE TIMELINES

The most important deadlines for a 1031 exchange are the identification and closing dates. Weekends and holidays are included in the deadlines. Investors must adhere strictly to the timeline in order to complete a successful 1031 exchange.

45-Day Rule: Within 45 days of the close of escrow for the relinquished property, an investor must identify any replacement property that will be purchased to complete the exchange.

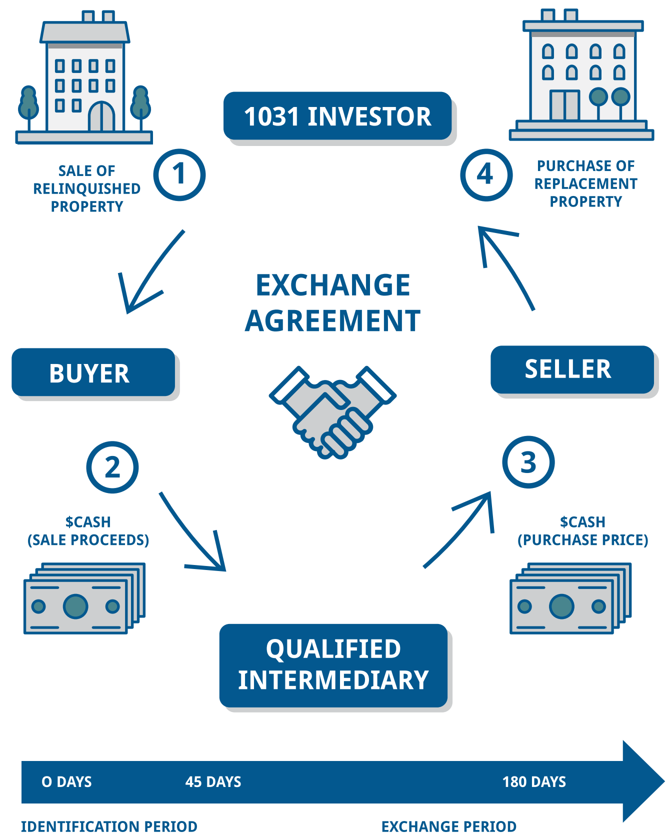
180-Day Rule: Within 180 days of the close of escrow for the relinquished property, an investor must close on the purchase of the replacement property identified to complete the exchange.

PUTTING IT ALL TOGETHER: HOW A TYPICAL 1031 EXCHANGE WORKS

The IRS outlines several different types of exchanges that allow for the deferral of capital gains and depreciation recapture taxes, but the most common is the delayed exchange. In a delayed exchange, the investor sells a rental property. The proceeds are held by a QI. The investor then has 45 days from the close of escrow to identify a replacement investment property and 180 days from the close of escrow to close on any identified property. After the investor identifies the replacement property or properties, the funds held with the QI can be utilized to purchase and close on the replacement property. The investor then takes title of the replacement property, and the 1031 exchange is complete.

OTHER CONSIDERATIONS

BOOT—In order for a 1031 exchange to defer the entire tax burden, all of the equity proceeds from the sale of the relinquished property must be reinvested in the replacement property. Any part of the proceeds of the relinquished property sale (whether cash or mortgage) not utilized or sheltered in a 1031 exchange is considered "boot" and subject to capital gains and depreciation recapture taxes.



Inheritance Benefits: A Step Up in Basis—Capital gains and depreciation recapture taxes can be deferred indefinitely through the use of 1031 exchanges. This tax burden can be avoided permanently through a "step up in basis," whereby heirs inherit property and realize a basis adjustment to the current market value as of the date at death or alternate valuation date. Heirs realize gains and taxes on sales only on those gains above this new, potentially higher valuation. Additionally, the heirs receive a new depreciation schedule, which can be utilized to shelter the property's income from taxes.

1031 EXCHANGE DO'S AND DON'TS

DO: CONSULT A TAX OR LEGAL PROFESSIONAL.

DO: UTILIZE A QUALIFIED INTERMEDIARY TO HANDLE YOUR EXCHANGE PROCEEDS.
If you take possession (constructive receipt) of the proceeds from the sale of your property, this will forfeit your ability to complete a 1031 exchange. A Qualified Intermediary is a company set up to handle the transfer and close of 1031 exchange funds so that investors do not take constructive receipt.

DO: CONTRACT WITH A QUALIFIED INTERMEDIARY THAT IS BOTH EXPERIENCED AND BONDED.
The QI must be able to handle your transactions in compliance with IRS guidelines and should have fidelity bonding to protect you from fraud. We can refer you to at least three QIs that meet these guidelines.

DO: IDENTIFY YOUR REPLACEMENT PROPERTIES IN THE IRS APPOINTED TIME.
The IRS provides 45 days from the close of escrow to indentify replacement properties.

DO: USE THE IRS IDENTIFICATION GUIDELINES TO YOUR ADVANTAGE.
The IRS provides three different identification rules to meet your replacement needs. Most people use the 3-Property Rule, but it is important to note that you can utilize the other rules in order to diversify your replacement property choices.

DO: REINVEST ALL EXCHANGE PROCEEDS THAT YOU DO NOT WANT EXPOSED TO TAX.
You pay tax on proceeds not reinvested.

DO: PURCHASE A PROPERTY WITH EQUAL OR GREATER VALUE.
If you acquire property that is of lesser value than the property you sold, you will have to pay tax on the difference.

DO: PURCHASE YOUR REPLACEMENT PROPERTY IN THE U.S. OR U.S. VIRGIN ISLANDS.
Foreign investment property does not qualify.

DON'T: FILE YOUR INCOME TAXES FOR THE YEAR IN WHICH YOU DO YOUR EXCHANGE UNTIL YOU COMPLETE YOUR EXCHANGE
Do this and lose the benefits of the exchange!

DON'T: REINVEST THE PROCEEDS IN PROPERTY YOU ALREADY OWN.
Do this and lose the benefits of the exchange!

DON'T: WAIT UNTIL THE LAST MINUTE
Time is important! You have 180 days from the escrow close to complete your purchase of a replacement property. Exceed this time limit and lose the benefits of the exchange!.

DON'T: DISSOLVE PARTNERSHIPS OR CHANGE THE MANNER OF HOLDING TITLE DURING THE EXCHANGE (WITHOUT CONSULTING AN EXPERT ON EXCHANGE ENTITIES).
Do this and lose the benefits of the exchange!

DON'T: FORGET THAT YOU MAY NOT NEED TO COMPLETE A 1031 EXCHANGE.
You may not need to complete a 1031 exchange if you do not have any material capital gains tax exposure. Make sure to consult the capital gains worksheet to determine your tax exposure. We also can refer you or your tax counsel to a CPA specializing in real estate to review your tax situation.

DON'T: OVERLOOK YOUR OTHER TAX-ADVANTAGED OPTIONS.
Though a 1031 exchange is often one of the best options for someone selling investment property, there are other options available that can provide further flexibility and diversification. For example, the Installment Contract and the 721 exchange allow investors to defer their capital gains after a sale but diversify their funds far more than the typical 1031 exchange. For a list of these and other options with analysis, please contact us at (877) 579-1031.

INTRODUCTION TO THE 721 EXCHANGE

Investors seeking to defer capital gains taxes while increasing diversification in real estate should consider utilizing a 721 exchange. Section 721 of the Internal Revenue Code allows an investor to exchange property held for investment or business purposes for shares in a Real Estate Investment Trust (REIT) without triggering a taxable event. The transaction allows investors to increase the liquidity and diversification of their real estate investments while deferring costly capital gains and depreciation recapture taxes that may result from the sale of a property.

Many REITs utilize section 721 as a method to acquire property from investors who are interested in selling their investment real estate but do not want to find a replacement property as part of a 1031 exchange or pay capital gains taxes. Rather than exchanging property for another property, an investor can utilize section 721 to contribute property directly to a REIT's operating partnership (the entity through which the REIT acquires and owns its properties) in exchange for operating partnership units. This transaction is often called a "721" or an "UPREIT" exchange.

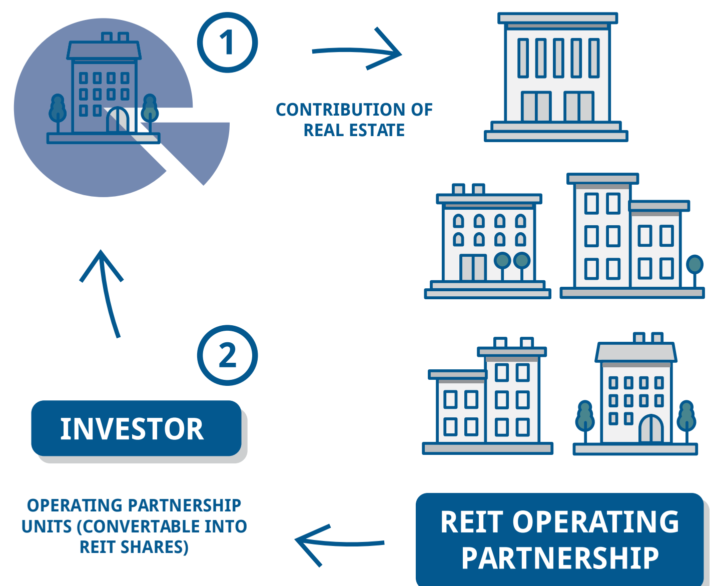
BENEFITS OF A 721 EXCHANGE

Taxes: In a typical property sale, the seller would pay taxes on the capital gains realized as well as the depreciation that was utilized to defer taxes on the property's income. The capital gains and depreciation recapture taxes could exceed 20–30% of the gains realized upon sale, leaving the investor with less capital for reinvestment. A 721 exchange allows investors to avoid taxes and keep their wealth working for them in a tax- deferred exchange of their investment property for shares in a REIT. REITs are required to distribute 90% of their taxable income in the form of dividends paid to shareholders. Dividends are declared annually by the REIT and typically are distributed monthly or quarterly.

Diversification: The 721 exchange enables an investor to achieve diversification across geography, industry, tenant, and asset class in a REIT structure. As a shareholder in the REIT, the individual investor participates in a diversified portfolio of real estate and is no longer concentrated and dependent on one asset to provide cash flow and appreciation. REITs also can provide the same ongoing benefits of real estate ownership including income, depreciation tax shelter, principal pay down, and appreciation. Many REITs continue to make acquisitions on an ongoing basis. This allows the investor to benefit from future buying opportunities in the REIT without triggering any capital gains or depreciation recapture tax events.

Estate Planning: The 721 exchange often is utilized as an estate planning tool to prepare an investor's real estate assets to be passed down to heirs. When direct real estate assets are passed to heirs they are often difficult to quickly liquidate and equally divide among heirs. Conflict may arise as to how or when assets are to be sold, and this can create other estate issues for the heirs. The 721 exchange provides a tailored solution that allows the estate to be prepared for easy transfer while deferring the capital gains taxes that have built up over the years. Before death and the passing down of the estate to heirs, the individual investor continues to receive dividend income. Instead of individual real estate assets, the heirs can receive easily divisible shares in a REIT that can be much more easily liquidated upon passing of the estate. Heirs who do not want or need funds may continue to hold shares in the REIT and receive the dividends. Regardless of the decision of the heirs, heirs receive a step up in basis that

721 EXCHANGE INTO A REAL ESTATE INVESTMENT TRUST (REIT)



permanently removes all capital gains and depreciation recapture taxes deferred in the estate. Beyond the estate planning benefits, the divisibility and liquidity of REIT shares allow investors to easily sell some of their shares if they are in need of capital.

Passive: The 721 exchange allows an individual investor to trade an actively managed real estate asset for a portfolio of real estate assets that are actively managed by the principals of a Real Estate Investment Trust. REITs allow individual investors to access and rely upon expertise provided by institutional asset management firms for all decisions regarding the real estate portfolio. REITs are passive investments, structured to provide acquisitions, property management, dispositions, investor communication, and the distribution of investors' income produced from the portfolio.

QUALIFICATION FOR A 721 EXCHANGE

In order for an investor to contribute a property to a REIT through an UPREIT transaction, the property must meet the REIT's investment criteria. Typically, most REITs target and require investments in institutional-grade real estate. Few individual investors own this type of property and therefore are not able to directly contribute a property to a REIT through a 721 exchange. However, by utilizing a 1031 exchange, an individual investor can exchange a property that does not meet a REIT's criteria for a fractional interest in a high-quality institutional-grade property. An investor then may have the opportunity to contribute that fractional interest to a REIT in a tax-deferred 721 exchange.

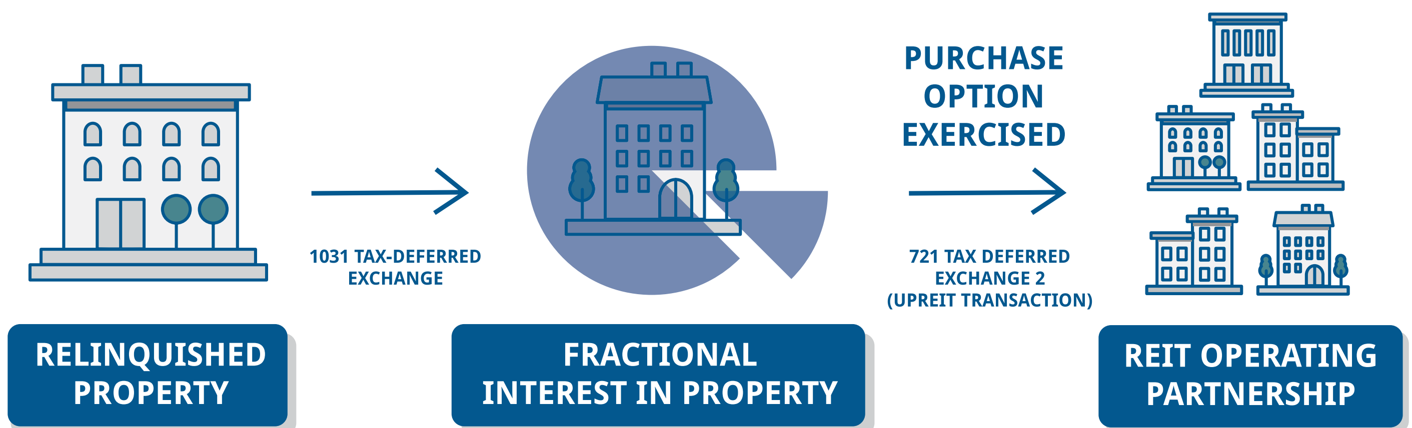
PUTTING IT ALL TOGETHER: HOW A 721 EXCHANGE WORKS

There are several real estate firms that facilitate the combination of the 1031 and 721 exchanges, allowing individual investors to access UPREIT transactions. For example, an investor can sell his investment or business property, (termed the "relinquished property") and, following the 1031 exchange rules, acquire another "like kind" property of similar or greater value. This "replacement property" is used as a rental or business investment property for approximately 12 to 24 months, demonstrating the investor's intent to hold it, thus qualifying for 1031 capital gains tax deferral. Then, the investor can "contribute" the "replacement property" to a REIT in exchange for the REIT's operating partnership units (OP units), which then are exchanged directly for shares in the REIT.

END OF THE 1031 EXCHANGE ROAD

Since REIT shares cannot be utilized in a 1031 exchange, the funds utilized in a 721 exchange transaction cannot be used in a future 1031 exchange. If shares in the REIT are sold, or if the REIT sells its properties and returns the capital gains back to investors, a taxable event would occur.

FROM THE 1031 EXCHANGE TO THE 721 EXCHANGE



INTRODUCTION TO TAX WRITE-OFFS AND CREDITS

For investors facing significant capital gains or income taxes, write-off and tax credit investments provide methods to reduce or eliminate tax exposure. As opposed to deferring taxes with the 1031 exchange, 721 exchange, and Installment Contract, the taxes owed can actually be canceled out or offset with tax write offs and credits. While tax write-off and tax credit investments provide significant tax benefits, it is important to distinguish between tax write-offs and tax credits and to note the trade-offs that are generally associated with these types of investments.

TAX WRITE-OFFS

Tax write-off programs can offset tax exposure by directly reducing the taxable income that one must report to the IRS. In the same way that a business owner is able to deduct certain expenses from income (thereby reducing taxes), the IRS provides an investor the ability to make certain types of tax-deductible investments that apply against income and capital gains. Investors are able to deduct a portion or all of their investment from their income, thereby directly reducing their tax exposure for that year and keeping more of their money working for them.

The IRS allows tax write-offs to be utilized against active and passive income. Therefore, investors are able to offset their capital gains tax exposure with a tax write-off investment. For example, if an investor in the 28% tax bracket sells a property for $200,000 and has a $20,000 tax exposure, he would be able to invest approximately $72,000 into tax write-off investments to eliminate his tax exposure. Tax write-offs are also able to reduce the alternative minimum tax up to 40%. The most common types of direct write-off investments include intangible drilling costs associated with oil and gas drilling investments. The IRS allows an investor to deduct 100% of the intangible drilling costs (IDCs) associated with an oil and gas program. Other write-off investments include alternative or “green” energy projects.

TAX CREDITS

Whereas tax write-offs reduce taxable income, tax credits are a direct, dollar-for-dollar reduction in taxes owed. A $10,000 tax write-off program can reduce income by $10,000, thereby indirectly reducing the taxes against that income. Investors in the 28% tax bracket would have an additional $2,800 on their taxes by way of a $10,000 write-off. In the case of a $10,000 tax credit, the investor can directly reduce their tax exposure by $10,000. Tax credits also may be used to offset alternative minimum tax exposure.

Low-Income Housing is the most common type of investment that provides direct tax credits. Typically, tax credits can be taken over a 10-year period for the rehabilitation of an asset that exists primarily for the benefit of affordable housing for lower-income individuals. Other tax credit investments include carbon reduction, energy-efficient, and alternative, “green” energy projects and redevelopment. Congress also has attempted to incentivize investors to revitalize areas devastated by natural disasters by providing tax credits for rebuilding projects.

THE TRADEOFFS OF TAX WRITE-OFFS AND CREDITS

Whereas section 1031 and section 721 of the Internal Revenue Code primarily exist to encourage long-term, domestic participation and investment into the U.S. real estate market, tax write-offs and tax credits typically exist to incentivize investors to take certain risks that they otherwise may not have participated in without tax benefits. To put it another way, many times, tax write-off and tax credit investments may carry a larger amount of risk in the underlying investment or investment strategy, which requires additional incentive, such as tax benefits, to ensure sufficient investor demand.

In some cases, the underlying risk of a particular investment may be heightened by its dependence on ongoing government support for financial gain due to favorable alternative or “green” energy laws that are currently on the books. We generally encourage investors to avoid any investment that requires government subsidization in order to be a financially viable project. The tax benefits of an investment should be an additional feature—not the primary factor in the decision-making process.

INTRODUCTION TO THE 1033 EXCHANGE

If an investor is required to relinquish their property through a “forced conversion,” the IRS provides an opportunity to defer capital gains taxes through the exercise of a 1033 exchange. Forced conversion occurs when a taxpayer’s property is reclaimed by eminent domain, condemned, or disposed of under threat of condemnation by a government or a quasi- government agency and the taxpayer receives payment in the form of money, other property, or a condemnation award. Forced conversion also applies when a taxpayer’s property is destroyed by a natural disaster and insurance proceeds are received. Fortunately, if an investor facing forced conversion follows the guidelines set forth in section 1033 of the Internal Revenue Code, they are able to complete a successful exchange and defer all of their capital gains taxes.

Without the special provision of the IRS, if an investor has any capital gains or depreciation recapture on the proceeds received from a forced conversion, they would have to pay taxes on the capital gains and depreciation in the same year they received the proceeds. This could exceed 20–30% of an investor’s proceeds received from the conversion. However, if an investor utilizes the provisions set forth in the 1033 exchange, both capital gains and depreciation recapture taxes can be fully deferred, allowing an investor the potential to maintain and continue to build wealth despite the forced conversion.

GUIDELINES TO QUALIFY FOR A 1033 EXCHANGE

Similar to a 1031 exchange, 1033 guidelines require an investor to reinvest proceeds from a forced conversion into a like-kind real estate exchange to qualify for full tax-deferment benefits. However, the tax deferral provisions and timelines of a 1033 exchange are typically much more relaxed and generous to the taxpayer than the 1031 rules and stipulations. In general, an investor seeking to complete a successful 1033 transaction should understand the type and value of assets that qualify for exchange and the timelines involved in completing an exchange.

1033 Exchange Asset Requirements: As with a 1031 exchange, a 1033 exchange is completed most often with a reinvestment of the forced conversion proceeds into “like-kind” investment real estate. “Like-kind” simply denotes that investment real estate must be exchanged for investment real estate. Personal residences and vacation homes that are not utilized primarily as rentals are not “like-kind” to investment real estate and do not qualify for a 1033 exchange. Though it is not as common, an investor in a 1033 exchange has other options in addition to “like-kind” real estate and even is allowed to select 80% control of a corporation owning replacement property to complete a successful exchange.

1033 Exchange Timelines: Whereas a 1031 exchange requires an investor to identify and close on replacement property within 45 and 180 days, respectively, from the close of the relinquished property, the 1033 exchange typically gives clients anywhere from two to three years from the date of the forced conversion to close on replacement, like-kind real estate to complete the exchange. Section 1033 does not have any identification requirements, which allows the client to select any number or combination of assets to complete a 1033 exchange. In order for a 1033 exchange to be considered complete, an actual purchase must take place, and title must be passed to the investor before the exchange deadline is up—an enforceable contract will not suffice.

Reinvestment Proceeds: By 1031 guidelines, clients are extremely limited as to how their reinvestment proceeds are handled in an exchange transaction. The 1031 client is never to take constructive receipt of the funds and must use a qualified intermediary to handle all proceeds from the close of escrow of the relinquished property to the close of escrow of the replacement property. Any funds handled directly by the client automatically become “boot” to the IRS and are taxed as capital gains.

The 1033 exchange is much more lenient with respect to how a client interacts with forced conversion proceeds. With a 1033 exchange, the client can take immediate possession and control over the funds in personal bank, money market, and investment accounts. No qualified intermediary is needed at any point throughout the 1033 transaction. The funds even can be placed into shorter-term investments until the close of escrow for any 1033 replacement assets. Any investment losses suffered by the taxpayer in the interim of the exchange period cannot offset the taxpayer’s requirement to complete a 1033 exchange that reinvests into a qualified replacement

investment with a value equal to or greater than the forced conversion. Therefore, it is important to keep 1033 funds safe and free from high-risk investments that could make completing an exchange difficult.

Reinvestment Requirements: The 1031 exchange requires investors to reinvest all equity and make an investment that is equal to or greater than the total value of the property that was relinquished. This typically requires an investor to either reinvest all equity, in turn taking on an equal or greater amount of debt than that which was held in the relinquished property, or add additional capital to their original equity to replace any debt that they cannot acquire. For example, if an investor sells an asset for $1M with $500,000 in net equity, they would be required to reinvest all $500,000 and take on an additional $500,000 in debt to complete a full exchange. Just reinvesting the equity is not enough. If, for some reason, they were unable to acquire any financing, they would have to come up with a total of $1M in equity to complete a full, tax-deferred exchange.

The 1033 exchange is very unique in that you do not have to reinvest all of your equity! If you are able to achieve greater financing than that which was held in the forced conversion, this can directly offset the amount of equity that must be reinvested as long as the total value of the replacement property is equal to or greater than the value of the forced conversion. The remaining equity that does not need to be reinvested is now completely tax-free and can be utilized at the investor's discretion. Whether investors are looking to fully reinvest equity or to implement this particular tax-sheltered cash strategy, we are able to help find the assets and structures that meet our investors' needs.

1033 Exceptions: Properties lost in Presidentially Declared Disasters that are compulsorily or involuntarily converted need not be replaced with "similar or related" property. In such circumstances, no gain is recognized by the receipt of insurance proceeds for unscheduled personal property that was part of the personal residence.

RECOMMENDATIONS

The 1033 exchange gives the investor a significant window of opportunity to complete a tax-deferred transaction without having to use a third-party entity to handle the funds. However, it should be advised that the exchanger not wait until the last minute to locate replacement property. Often, investors are lulled into a sense of false security by the fact that they do not face the stringent rules that they would under a 1031 exchange. They can allow their 1033 transaction to lapse until it becomes very difficult to find and close on the most suitable replacement property. We recommend that investors take the full benefit of the increased timeline of a 1033 exchange to remove the pressure that can occur in a 1031 transaction. On the other hand, investors should take a proactive approach that puts their capital back to work for them in well- researched, suitable replacement properties that meet their investment objectives.

PART 2:

Real Estate Investment Solutions

REAL ESTATE INVESTMENT SOLUTIONS

Whether a client's real estate purchase is motivated by tax deferral or real estate diversification, the benefit from this section is its focus on the fundamentals of real estate analysis, investment, and ownership. This section will equip investors with the essential aspects of investment real estate and help them identify the types of investments that are right for their particular needs and objectives.

REAL ESTATE OWNERSHIP TYPES (PAGES 18-19):

This article addresses the three most common forms of legal real estate ownership as well as the rights and tax consequences associated with each manner of holding title. It is important to distinguish between the different ownership types, as each carries significantly different risks and potential returns.

REAL ESTATE INVESTMENT STRUCTURES (PAGES 20-23):

This article primarily focuses on the different types of legal investment structures that investors utilize to participate in real estate ownership. Each investment structure is broken down in detail regarding 1031, 721, and 1033 exchange compatibility, diversification potential, control, minimum required investment, third party management, and asset manager profit participation.

INTRODUCTION TO NET-LEASED REAL ESTATE (PAGES 24-26):

This article deals briefly with the current state of the economy and the particularly stable, recession-resilient returns of certain types of net-leased (NNN) investments as compared to other asset classes of real estate. This article delves into the primary aspects of net-leased (NNN) properties and weighs both the general benefits and drawbacks of this asset class.

CORPORATE CREDIT RATINGS (PAGE 27):

This is a brief description of corporate credit ratings and their role in helping investors make solid investment decisions.

WHAT TO LOOK FOR IN SINGLE-TENANT NET-LEASED PROPERTIES (PAGES 28-29):

This article breaks down some of the most important elements of locating suitable real estate investments by helping the client examine the 1) location, 2) asset, 3) tenant, 4) lease, and 5) ownership structure of investment real estate. While this article is applied specifically to long-term, triple-net leased property, each of these five elements can be applied to nearly any asset class of real estate to help an investor perform more comprehensive investment research and analysis.

ANALYZING LEASE TERMS (PAGES 30-32):

This article covers lease obligations, the balance of tenant and landlord rights and liabilities, the necessity of "lease bumps," renewal options, and the issues regarding early termination and co-tenancy clauses. By the end of this article, the investor should be better equipped to identify or even negotiate the right types of leases.

PRIMARY TYPES OF SINGLE-TENANT NET-LEASED PROPERTIES (PAGES 33-36):

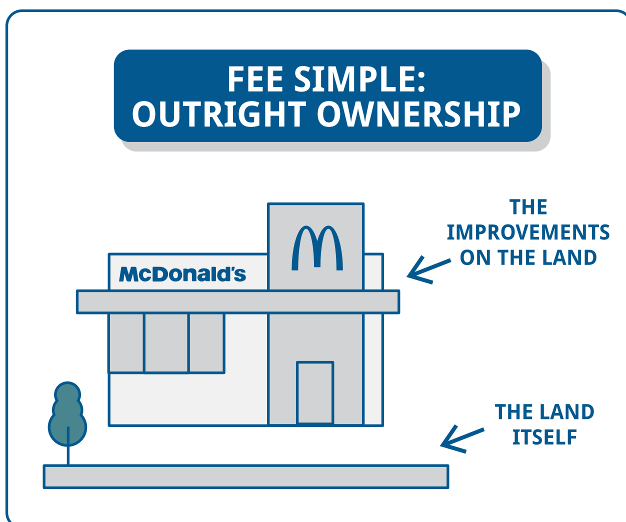
This article provides a summary description of many of the major categories of net-leased (NNN) property, including necessity retail, fast food, gas stations, vehicle repair, etc. Stronger tenant selections are highlighted within each category summary.*

*A full net-leased (NNN) property tenant/property profile spreadsheet is available upon request.

REAL ESTATE OWNERSHIP TYPES: KNOW YOUR COLLATERAL AND RIGHTS

It is essential that investors know exactly what they own when purchasing real estate. For instance, if investors are considering the purchase of a property with McDonald's as the tenant, are they buying both the land and the building, just the ground under the building, or only limited rights to the building without ownership of the land underneath? Each type of ownership provides significantly different rights, returns, tax benefits, and risks. Therefore, it is important to be able to identify the different types of ownership and know the benefits and drawbacks of each.

There are three common forms of real estate ownership: **fee simple, leased fee, and leasehold interest.** Fee simple ownership is the most complete form of ownership available to most investors. Fee simple ownership includes title and rights to both the land and any improvements (such as buildings) located on the land. Leasehold interests effectively split ownership of the land and the improvements, whereby the land is owned outright by one party (lease fee), and the use of the land or the improvements on the land is leased for a very long time to another party (leasehold interest). This leasehold interest structure then forms two additional common ownership types; one party can be the outright owner of the land, and another party can be the outright owner of the improvements located on the land.

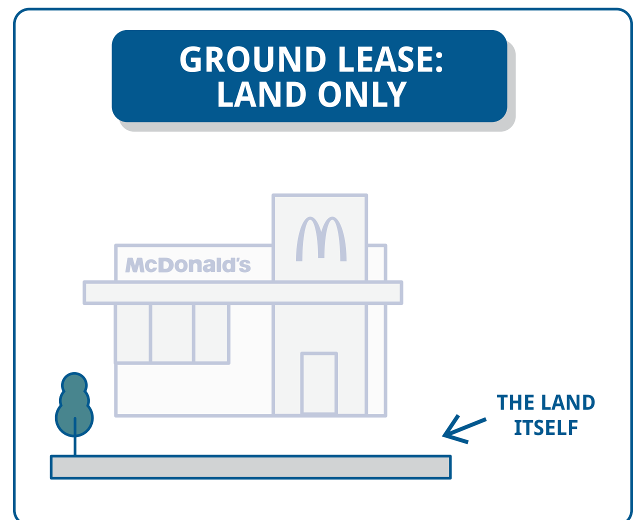


FEE SIMPLE: OUTRIGHT OWNERSHIP

Fee simple ownership gives the owner the title and rights to the land and any improvements on the land. In the case of the McDonald's example, the owner would own the land, the building tenanted by McDonald's, and any other permanent structures located on the property. The owner would have the choice to renew the restaurant's lease when it came due and would have authority to make any other property- related decisions. From a tax standpoint, the owner could utilize depreciation to shelter rental income based on the value of all of the improvements on the land. The land could not be depreciated.

LEASED FEE: LAND OWNERSHIP

In the case of leased fee ownership, the land owner owns the title and rights to the land, but use of the land and any improvements on the land is leased to another party for a specified period of time. This leasehold interest structure is referred to as a "ground lease" and typically lasts in excess of 40–50 years. This type of ownership is regarded as the most secure form of real estate ownership because the land owner generally does not retain any liability in the operations of any of the improvements. Moreover, upon any event of uncured default of the lessee or upon the end of the ground lease term, all of the improvements and the use rights thereof revert back to the land owner.



Utilizing the McDonald's example, the land owner in a ground lease would own the land but not retain the rights to use the land or the McDonald's building or any other permanent structures until expiration of the ground lease. The land owner typically would have no say in the matter

of choosing to renew the restaurant's lease when it came due if the renewal option occurred within the ground lease period. From a tax standpoint, the owner could not utilize the improvements on the land for depreciation shelter. Since land cannot be depreciated, the land owner would not have any depreciation to shelter the ground lease income.

LEASEHOLD INTEREST: IMPROVEMENTS AND LAND-USE OWNERSHIP

In a leasehold interest, the improvement owner typically owns a building and any other permanent improvements that are located on land that the improvement owner leases from the land owner on a long-term ground lease. The leasehold or improvements owner retains rights to use and receive rent from the use of the land for as long as the ground lease is in place. This type of ownership is regarded as the least secure form of common real estate ownership because all of the improvements and the use rights thereof revert back to the land owner upon the end of the ground lease term.

With the McDonald's example, the leasehold or improvements owner would retain the rights to use and receive rent from the use of the land or the McDonald's building or any other permanent structures until expiration of the ground lease. The improvements owner typically would have full control in the matter of choosing to renew the McDonald's lease when it came due or in any other property-related decisions within the ground lease period. From a tax standpoint, the improvements owner could utilize all of the improvements on the land for depreciation shelter. Since the improvements owner would not own the land, he would be able to fully depreciate the value of his ownership interest in the improvements.

According to the IRS, leasehold or ground lease interests must have terms that are 30 years or more in length (including available renewal options) in order to qualify for a 1031 exchange purchase. It is advisable to keep this in mind not only for the original purchase but also for the next purchaser down the line. If an exchanger buys a property with only 30 years remaining on its ground lease, it may qualify for its own 1031 exchange, but by the time the exchanger looks to resell the property, it would not qualify for another purchaser's 1031 exchange. This would reduce the number of potential buyers and demand for the property and likely hurt one's ability to recoup the original investment.

RECOMMENDED OWNERSHIP TYPES

Despite the tax benefits and higher income that can be associated with improvement ownership on a ground lease, we tend to avoid this form of ownership. Unless the ground lease term is in excess of 50 years and in areas of the country where excess demand and limited supply of land have required states to step in and offer ground lease ownership to promote business growth (such as Hawaii, New York, and parts of Florida), improvement-only leasehold interest ownership poses significantly more risk to the owner, as the underlying ground lease may not be renewed at the end of the term. That being said, we primarily advise investors to target leased fee and fee simple ownership, as we believe that these types of ownership offer more secure forms of real estate ownership and a better long-term ability to maintain property value. If investors require tax shelter on their income, fee simple ownership provides both depreciation and greater ownership security.

REAL ESTATE INVESTMENT STRUCTURES

Real estate ownership is often thought of only in the context of owning an entire building or portfolio of buildings outright. Sole-ownership, however, is only one of the multiple investment structures that accommodate real estate ownership and investment

participation. Investors are able to utilize many different types of investment structures for real estate ownership to meet their tax deferment and investment objectives. This article will provide a summary description of each primary investment structure and its particular application to the individual investor. Each of these investment structures can be implemented with the same real estate assets: It is only the investment structure that changes, not necessarily the underlying real estate.

SOLE-OWNERSHIP

Sole-ownership is the most direct and controlling form of ownership, whereby the owner holds direct title to the entire asset and is able to make all decisions regarding its use, financing, and disposition. If structured properly, sole-ownership investment real estate qualifies for a 1031, 1033, or 721 tax-deferred exchange. The benefit and burden of sole-ownership property is direct control/ responsibility.

The owner is able to make all of the property-level decisions but is also responsible for the liabilities of the property. Typically, to obtain financing for sole-ownership real estate, owners must sign for recourse debt—which obligates them to pay the debt, regardless of what occurs with the asset. Sole-ownership is best for clients who want to manage and control real estate directly and who have a significant net worth with plenty of liquid funds to purchase and properly maintain larger real estate assets.

One limiting factor of sole-ownership is that is does not facilitate diversification for most higher- net-worth real estate investors. In the case of smaller commercial real estate, such as net-leased (NNN) retail properties with national tenants, sole-ownership typically requires a total purchase price of $1,000,000 to $3,000,000 and a down payment of $500,000 to $1,250,000. With many larger, commercial properties, the sky is the limit on both purchase price and down payment requirements. Most larger, institutional-type commercial assets in stronger locations command purchase prices in excess of $15 million with down payments in excess of $6 million.

For institutional and family office clients with a net worth in excess of $30 million, diversification into smaller commercial real estate via the sole-ownership structure may not be an issue because the available investment funds can be significantly greater. Institutions with investable, available assets in excess of $1 billion are able to build relatively diversified portfolios in both small

Investment structure	How is Title Held?	1031 Exchange?	Liquid?	Control?	Avg. Min. Investment?	Number of Properties?
Sole-Ownership	Held directly	Yes	No	Owner	$500,000	1
Tenant-In-Common (TIC)	Held directly	Yes	No	% vote	$250,000	1-3
Deleware Statutory Trust (DST)	Held by the trust for benefit of the investor	Yes	No	None	$25,000	1-30
Real Estate Investment Trust (REIT)	Held by the Corporation	No	Semi-Liquid	None	$2,000	50-100+
Real Estate Fund (LLC/LP)	Held by the Partnership	No	No	None	$25,000	10-25+

and large commercial real estate. For most individuals with a net worth of $30 million or less, the sole-ownership investment structure greatly limits the level of diversification possible.

TENANT-IN-COMMON OWNERSHIP

Tenant-In-Common (TIC) ownership references a way of taking title to real estate with each owner possessing an undivided, fractional interest in an entire property. Tenant-In-Common investment structures began in the 1600s in England. They provided real estate investors an alternative to partnerships. They are popular because of their tax-deferred exchange qualifications. Since the early 2000's, the Tenant-In-Common structure has been packaged as an investment security, and it has become common for individual real estate investors in completing their 1031 exchanges.

As the nation's real estate market heated up through the early to mid 2000s, 1031 exchange investing became even more popular. However, the IRS-imposed time restrictions on the 1031 exchange (45 days to identify property; 180 days to close) became difficult for investors to meet. As a result, the Tenant-In-Common structure began to be packaged more regularly as a security in early 2001 and 2002. Investors were able to make much smaller investments without sacrificing the quality of the real estate to complete their 1031 exchange. Furthermore, many Tenant-In-Common properties came "pre-packaged" with due diligence information and financing already in place. This allowed investors to more easily identify and close on investment real estate and comply with the 1031 guidelines. In 2002, the IRS released Revenue Procedure 2002-22, giving 15 guidelines to consider when using Tenant-In-Common real estate as like-kind replacement property–and the fractionalized real estate industry took off.

Whether a Tenant-In-Common structure is applied with two investors or up to 35 investors (the IRS limit), the structure and setup are the same. Owners possess an undivided interest in the property according to their proportionate investment and are able to receive 100% of their share of the cash flow, tax benefits, and sale profits from the property. Typically, Tenant-In-Common investments are managed by a third party who is responsible for the day-to-day management decisions at the property level.

Tenant-In-Common real estate functions and can be handled similarly to the practice of sole- ownership, with the exception of the decision making process. Major decisions in Tenant-In- Common properties are governed by a "Tenant-In-Common Agreement." The agreement outlines governance procedures to approve or decline material decisions. Certain decisions–such as refinance or disposition–must be unanimous. The Tenant-In-Common Agreement may include buyout provisions and rules to avoid having any particular investor act as a holdout against the majority of investors.

Tenant-In-Common properties provide investors with access to institutional properties but with smaller minimum investment requirements. Each asset's purchase price can be split among up to 35 separate investors. For example, a $30-million building with 65% financing may require a minimum investment of only $300,000. Lower-cost commercial real estate may accommodate investments of $150,000 or less. The Tenant-In-Common structure allows investors to take title to and participate in large, institutional-type real estate for a fraction of the cost of one-hundred- percent ownership.

The primary drawback to a Tenant-In-Common investment is that any one investor does not have complete control. Each Tenant-In-Common investor is able to vote their percentage interest in ownership for major property decisions. Tenant-In-Common investments are for clients who do not require complete control over all property decisions. This structure is best for clients who are seeking 1031-compatible, institutional-type replacement property managed on their behalf and capable of providing rental income.

DELAWARE STATUTORY TRUST OWNERSHIP

Similar to the Tenant-In-Common structure, the Delaware Statutory Trust (DST) provides a means of real estate ownership that is undivided, fractional, and compatible with the 1031, 1033, and 721 tax-deferred exchanges. In October of 2004, the IRS provided revenue ruling 2004-86, which defined the Delaware Statutory Trust structure as eligible to be like- kind property. Delaware Statutory Trusts also can be syndicated like Tenant-In-Common investments so that the due diligence information, financing, and closing can be coordinated to accommodate the needs of the 1031 exchange timelines.

In a Tenant-In-Common structure, each owner holds title to the real estate directly. In a Delaware Statutory Trust structure, each investor holds title to the real estate

through a beneficial interest in the trust. The DST structure is completely passive. All major property decisions are made by the trustee of the trust and the asset manager, rather than by vote of the Tenant-In- Common owners.

The Delaware Statutory Trust is not limited to 35 investors, but rather can accommodate up to 1999 investors. While most DSTs never have more than 150 investors in any one offering, the increased investor limits serve to dramatically decrease the minimum investment required for these types of investments. Typically, the minimum investment for DST-structured real estate is $25,000 to $50,000. This accommodates greater diversification opportunities for the individual investor.

The IRS 1031 exchange guidelines for the Delaware Statutory Trust are relatively inflexible. For a DST to qualify for a 1031, it cannot undergo any material change of the leases to the tenants unless there is a tenant bankruptcy or default. Additionally, the DST may not refinance throughout the investment hold period. These requirements limit 1031-qualifying DST investments to assets with large, national tenants with long-term triple-net (NNN) leases and longer-term financing in place. Some providers of DST investments will place a triple-net "master lease" on a multi-tenant property whereby the provider is obligated to pay a certain level of rent to the investors, regardless of what happens to the building's tenants. This allows the underlying leases to be rolled over, renewed, or changed, if need be, without disrupting the 1031 status of the DST.

The Delaware Statutory Trust is an investment structure appropriate for clients seeking passive ownership in real estate. The DST structure is not appropriate for assets that have short-term financing. This investment structure is best suited for individuals with a net worth greater than $1 million who require 1031-compatible replacement property and are targeting stable income- producing real estate assets with a longer-term hold period and active, third-party professional management.

REAL ESTATE INVESTMENT TRUST

A Real Estate Investment Trust (REIT) is a company that exists for the purpose of acquiring, managing, and selling real estate for the benefit of shareholders. REITs are utilized by clients seeking to participate in real estate with the potential for income and capital appreciation, invested primarily in diversified portfolios of commercial real estate. Unlike sole-ownership, Tenant-In-Common, or Delaware Statutory Trust ownership structures, REIT investments cannot be used to accommodate a 1031, 1033, or 721 exchange. Larger REITs typically raise $1–2 billion dollars and build portfolios of investment real estate over a 2–5 years that involve dozens or even hundreds of properties. Though there are items on which REIT shareholders will vote, REITs are primarily passive investments whereby the management makes all of the property-level decisions

The REIT structure may be used to target any asset class of commercial real estate available. Some REITvs are classified by specific asset class, while other REITs will be open to all asset classes to build an internally diversified portfolio. A REIT may target purchases of equity, debt, or a combination of both in its portfolio. These variations allow clients to build selective investment portfolios within the commercial real estate space without requiring large minimum investments that most real estate investing requires. The minimum investment required for non-traded REITs is typically between $1,000 and $5,000, providing clients with a much easier entry point to get exposure to real estate investing.

Another major difference between the REIT and sole-ownership, TIC, and DST investments is that REITs allow the managers to share in a portion of the cash flow and profits. By law, REITs are required to distribute 90% of their taxable income—and upon disposition of the assets in the REIT, the manager typically takes between 5% and 15% of the upside beyond the clients' return of capital invested and a certain level of minimum return per year. Most REITs share in profits after the investors have received a return of their original investment in addition to a minimum range of a 6–10% return on their investment per year.

REITs are best suited for clients who are seeking stable, diversified approaches to real estate investing or who are new to real estate investing in general. REITs are not compatible with or appropriate for 1031 exchange needs. Many REITs are non-traded, meaning that while they have to publicly report their financial information, they are not required to trade on a stock exchange. Many REITs have early liquidation accommodations for investors who need to get their money out earlier than the REIT hold-period. Most non-traded REITs have liquidation targets of about 3–8 years.

REAL ESTATE FUNDS (LLC OR LP STRUCTURES)

Real estate ownership also can be structured in a Limited Liability Company (LLC) or Limited Partnership (LP) format, pooling multiple investors into a fund that invests in real estate assets.

Similar to REITs, real estate funds are passive investments whereby investors rely on centralized, third-party management for the acquisitions, finance, management, and dispositions of real estate. LLC and LP investments cannot be used for an investor's 1031 exchange. Unlike in REITs, LLC and LP investors are members or partners instead of shareholders, and the managing member or general partner in these fund structures is responsible for the management of the real estate in the fund.

Real estate funds typically target either higher-risk and higher-return investments or smaller investments that would not justify a more expensive REIT structure. Most real estate funds range in size from $25 million to $50 million in total equity and from $50 million to $150 million in total real estate assets. Many LPs and LLCs are set up to return an investor's original investment and a certain level of return on capital per year before the manager can participate more significantly in the profits. Since LLCs and LPs typically are able to admit up to 499 investors in their funds, the investment minimum is typically between $25,000 and $50,000.

Real estate funds are extremely diverse in their range of allowable real estate investments. They can target debt or equity purchases in every type of asset class at any stage of development as outlined in the fund agreement. Real estate fund liquidation dates range between 18 months and 10 years, depending on the fund and the business strategy. That being said, most funds are similar to REITs in that they target 3–5 years for liquidation.

Real estate funds are appropriate for sophisticated clients with a net worth in excess of $1 million who are pursuing higher-risk, higher-return potential strategies in real estate. Real estate funds are not used to complete a 1031 exchange, for investors who want direct management control, or for investors who need near-term liquidity for their original investment. Many real estate funds provide unique management strategies that allow investors to achieve higher risk-adjusted returns that are not correlated with the stock market or other traditional investments,

INTRODUCTION TO NET-LEASED REAL ESTATE

We are working with clients to acquire investment-grade, long-term net-leased real estate if they are selling their real estate now and considering a 1031, 1033, or 721 exchange. For clients diversifying a portion of their portfolio for wealth management purposes (i.e. not in a 1031 or 1033 exchange), we are also utilizing net-leased real estate options, but in a different investment structure altogether.

In light of the current real estate market conditions, we believe that investment grade, long-term net-leased real estate is well-suited to provide stabilized income in the midst of potential ongoing economic turbulence. Caution is warranted however, as many investment grade tenanted properties in the net-leased space have seen their values rebound back to levels not seen since prior to the start of the Great Recession.

WHAT ARE INVESTMENT-GRADE, LONG-TERM TRIPLE-NET LEASES?

"Investment-grade, long-term triple-net leases" is a term that refers to the primary aspects of a particular lease structure. "Investment-grade" describes the qualities of the tenant with which the lease is made. "Long-term" refers to the general length of the lease, and "triple-net" refers to the structure of the lease obligations.

Investment-grade: Investment-grade leases are leases to tenants that maintain a credit rating of BBB- or higher. This investment rating is given by S&P's, Moody's, or Fitch, and it represents a company's ability to repay its obligations. BBB- represents a "good credit rating" according to the rating agencies. Typically, only larger, national companies maintain these stronger credit ratings.

Regional tenants and franchises are too small for the rating agencies to track. Therefore, in most cases, we recommend that your lease is corporate-backed—backed by the parent company and not just a regional franchisee. There is a very big difference between the credit and strength of a regional McDonald's franchise owner and the McDonald's Corporation. The corporate parent generally will provide greater rent stability in the midst of economic downturns. Rent stability also translates into greater stability for the value and price of your real estate. The price of your asset is directly tied to the income it produces and the likelihood of that income continuing for a future buyer.

Long-term: Typically, "long-term" describes a fixed-length obligation in lease term at or beyond 8 to 10 years. Some brokers or advisors may include lease options as a part of the fixed lease term. It is important to distinguish between the options and obligations. If the tenant has the option to renew for 5 more years after an initial 5-year term, the lease term should be considered a 5-year lease with another 5 years in options—not a 10-year lease. Find out rent terms and how long the tenant is obligated to pay. It makes all the difference when considering your risk, returns, ability to obtain financing, and your ultimate ability to resell the property for a profit.

Triple-net (NNN): Triple-net (NNN) leases are leases whereby the tenant is responsible for all operating expenses, including taxes, insurance, the structure, and the roof. A pure NNN lease that will cover these costs throughout the term of the lease is often referred to as an "absolute NNN lease." Some leases are called "triple-net" that do not include the expenses of the roof or structure of a building. These types of leases are more accurately referred to as "modified NNN" or "double-net" leases.

It is important to differentiate lease types when considering investment property. Many brokers refer to both pure triple-net and modified double-net leases as the same type of lease. There is a very big difference! Roof and structure repairs can be very costly and may provide your tenant an early out for their lease obligations if the structure is not maintained properly. True triple-net (NNN) leases place the burden of all of the operating and structural expenses on the tenant, and thus tend to be substantially more expensive than modified and double-net leased properties. Modified NNN leases can be appropriate if the price is right and/or if the structure and roof are relatively new and if they come with substantial, long-term guarantees of quality and maintenance from the original installation company or developer.

BENEFITS OF INVESTMENT-GRADE, LONG-TERM NET LEASES

Stability: Investment-grade, long-term net leases may provide stability of income and value to investors despite difficult economic circumstances. The lease payments typically are backed by some of the country's strongest corporations. Whereas smaller, regional tenants (or even

individuals in apartment assets) may struggle to make rent payments, large, profitable, and well- capitalized companies are often in a much better position to maintain their obligations despite the economy's twists and turns. A strong tenant tied to a long-term lease can significantly reduce an investor's downside exposure in a volatile market.

Predictability: By their very structure, long-term triple-net properties may allow investors to predict, far in advance, their future stream of lease payments throughout the lease term. All of the terms, payments, increases, etc. are defined ahead of time in the lease agreement. Whereas an apartment complex may have to lower rents in light of the downturn as the leases come up every 6 to 12 months, the typical net-lease structure is longer and tied to the strength of the company's entire balance sheet.

Simplicity: Long-term triple-net leases are generally more simple to manage, as most of the operational, maintenance, tax, and insurance obligations fall to the tenant. The landlord is responsible to provide the real estate as agreed upon at the initial term of the lease. The maintenance and insurance are the tenant's responsibility, and if the property is damaged, the tenant would be responsible to maintain and restore the property for their use at their own expense. With many absolute NNN leases, the tenant must continue to make lease payments to the landlord even if their building is no longer operational. In summary, triple-net leases provide owners with simplicity and the ability to enjoy the benefits of real estate ownership without many of the major management headaches (tenants, toilets, trash, termites, etc.).

Long-term modified and double-net leases require more management than triple-net leases because some of the structural obligations are borne by the landlord rather than the tenant. For example, a typical double-net lease will require the landlord to maintain roof, structure, and the parking lot. Generally, double-net leases will require reconciliations of taxes and insurance that must be calculated annually or biannually. In short, there is more to manage with double-net leases when compared to triple-net leases, which often provides an opportunity to buy double-net leased properties at a relative discount.

DRAWBACKS OF INVESTMENT-GRADE, LONG-TERM TRIPLE-NET LEASES

Single-Tenant Dependence: The largest drawback to investment-grade, long-term triple-net leased real estate is that if your primary tenant defaults, it can be very difficult to find another tenant to replace the original. If financing is tied to the property, it can add significant stress to your cash flow as you continue to service your debt while finding another tenant. Additionally, the new tenant will require some level of tenant improvements—funds that are used to prepare the space for the new tenant's specific floor plan and setup.

Upside Limitations: The same benefits that provide stability and downside protection also provide a limit to your upside potential. Unlike apartments or commercial property with shorter-term leases that can be increased consistently with an increasing market, long-term net leases are fixed for extended periods of time that do not allow for reactions to short-term market fluctuations. Therefore, it is rare for a long-term net-leased investor to experience tremendous upside appreciation upon reselling the asset. Though there are often rental increases as part of the contractual lease obligation, these rental increases are typically limited to 1–2% per year or less for stronger tenants.

An investor may get more upside out of this type of investment during instances of heavy discounting due to market turmoil. During a recession, opportunities can be created when sellers are forced to dispose of their strong assets at a discount to raise capital for their other portfolio needs and cash shortfalls. This phenomenon allows prepared investors to take advantage of market discounts and get more favorable prices and lease terms than would have been otherwise available in a stronger market.

OTHER CONSIDERATIONS OF LONG-TERM TRIPLE-NET LEASES

Location: The strength of a tenant or lease terms does not eliminate the need for proper research and due diligence on a property's location. Real estate is driven ultimately by demand. Commercial real estate is largely driven by its ability to provide consistent, reliable, and increasing income. Income is driven by a tenant's desire to take space in a particular location, and income is increased and made more secure when that tenant demand is consistent, increasing, and spreading to a growing number of participants. Tenant demand is driven by their ability to make a profit in a particular retail location, which is tied to the income growth and consumer traffic of the area. Income growth and consumer presence is directly tied to

the job growth and population growth concentrated in the particular area. At the end of the day, we can target which areas will receive strong tenant demand and real estate rental growth by tracking population and job growth as the primary determinants of consumer demand for a particular location. Therefore, we arrive back to three most important aspects of all real estate: *location, location, location.*

The location must not only provide consumer and commercial demand, but it is also wise to ensure that a particular property location is important to the parent corporation. For instance, when Starbucks decided to close more than 600 stores nationwide, it chose the assets that were losing money—that were not vital to operations. If possible, determine how well a particular location is performing for the corporation. It may be difficult to get these numbers, but it may be possible to survey the amount of retail traffic and consumer business conducted at that particular location. When we assist our clients in locating suitable replacement property, we seek to provide them with properties that have strong tenants, strong lease terms, and strong locations.

Balance Sheet Strength: Investment-grade ratings are not enough to determine a tenant's strength! Credit ratings can be used effectively to weed out weaker tenants yet should not be relied upon solely to choose viable tenants. Investors must consider the company's financial statements to make a suitable investment determination. Companies with an investment-grade credit rating have balance sheets, statements of income, and statements of cash flow that are publicly available. It is important to understand a tenant's current assets, cash equivalents, and liabilities. In other words, how much cash do they have on hand? What liabilities are they going to have to pay into the future? Are they heavily indebted? Is their revenue subject to decline? Are their expenses rising materially? Each of these questions should be answered before an investor makes the decision to depend upon the company's abilities to meet its obligations. We encourage our clients to have a CPA review the tenant company's financials before they make their investment decision.

Business Strength: "Business strength" refers to a company's ability to generate ongoing revenues through its primary operations. A company may have a strong balance sheet and an investment-grade credit rating, but if its primary business is facing risks of obsolescence, intense competition, major trend changes, financial pressures, or government interference not previously experienced, it may be best for an investor to pass. Avoid the risk if the company cannot shift its business quickly enough to avert major operational and fiscal issues. Our clients often target those companies that provide necessity products and services such as food, groceries, gas, pharmaceuticals, healthcare and medical supplies, discount clothing, discount domestic and home improvement supplies, discount automobile supplies and repair, transportation and information carrier services, and infrastructure and utilities equipment and services. While we believe that there are certainly other types of companies that can do well in stronger markets, we believe that sticking to consumer necessities will help protect our clients from initial and ongoing effects of a downturn.

CORPORATE CREDIT RATINGS

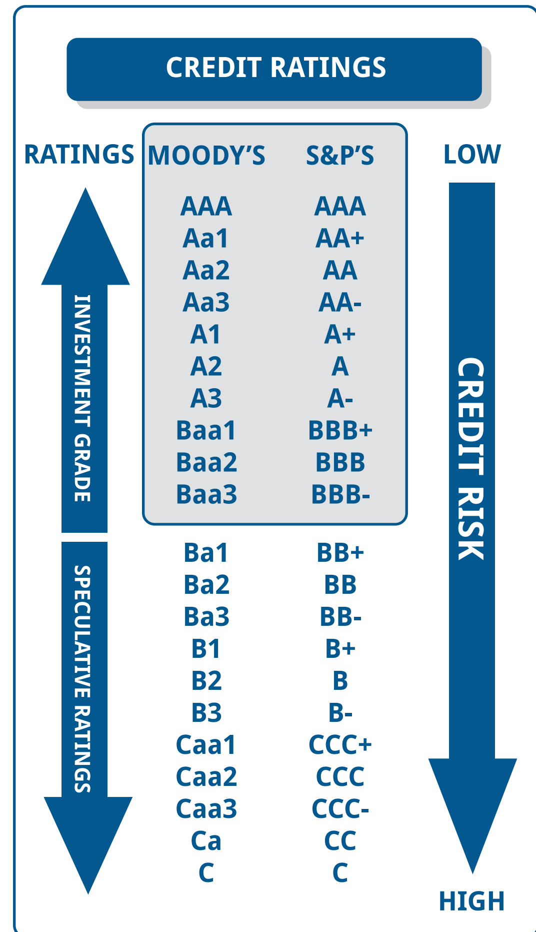
Corporate credit ratings are issued by rating agencies in order to provide investors with better insight into how well a particular organization is operating and able to pay off its liabilities and financial obligations. The three largest rating agencies are Moody's, Standard and Poor's (S&P), and Fitch. Typically, these agencies will track and issue credit ratings for larger, national, and publicly traded companies.

The highest credit rating issued by the rating agencies is "AAA" and held by a small number of companies. Any corporate credit rating above BBB- (S&P's) or Baa3 (Moody's) is considered "investment grade." Any corporate credit rating below BBB- or Baa3 is considered an indicator of higher risk and refers to "speculative" or "junk" status. In light of the current economy, it is recommended that real estate investors select tenants that have an investment-grade credit rating.

USING CREDIT RATINGS TO IDENTIFY STRONGER INVESTMENTS

Since corporate credit ratings indicate the ability of a particular company to repay its obligations and liabilities, ratings can be useful in helping investors determine the strength of potential tenants as well as certain debt instruments. However, credit ratings alone are not a sufficient indicator of financial strength. An investor must review a corporation's current balance sheet, income statement, and statement of cash flows to obtain a comprehensive perspective of the corporation's financial health.

If you would like more information on the strength and credit of a major corporation, please let us know. We would be happy to help. We also provide our investors with detailed lists of corporations and their credit ratings as one strategy to quickly filter out weaker tenants and target stronger investment opportunities.



WHAT TO LOOK FOR IN SINGLE-TENANT NET-LEASED PROPERTIES

Long-term, single-tenant triple-net properties can be one of the most reliable forms of income- producing real estate ownership, provided that you have the right 1**) location, 2) asset, 3) tenant, 4) lease, and 5) ownership structure** in place.

This article will address how these aspects of net-leased real estate ownership are reflected in each of the primary categories of net-leased property.

1. **Location**: The right location includes the concepts of "replace-ability" and tenant demand. Often, net-leased investors ignore the importance of location, relying most heavily on the strength of the primary tenant to offset a weaker location. While location risk can be diminished by a strong, national tenant, the better investment choice includes a strong tenant in a strong location. The cost of the asset often will be higher for the better location, but the ability to replace a tenant in a location that provides greater demand can provide irreplaceable downside protection.

2. **Asset:** The right asset includes the right type and condition of the asset as well as the price paid for the asset. Cost and condition are interdependent in real estate. In other words, a low-quality asset may make a great purchase at a severely discounted price, whereas the best real estate location in the world may make a bad purchase if the buyer pays too much. The right type of asset, in the context of net-leased properties, simply takes into account the ability to place other tenants in the space, if need be. A property fully customized to one particular tenant can be very difficult to fill in the event that the original tenant defaults or does not renew their lease.

3. **Tenant:** Who is the right tenant? In a particularly volatile economy, for those looking for stable income, we recommend assets with strong, national tenants with little to no debt or with a credit rating that is at or above investment grade (a credit rating BBB- or better). When looking for the right tenant, an investor must distinguish between corporate-backed and franchise-backed leases. The strength of a particular brand or chain of stores may indicate the popularity of their product or service, but it may not indicate the strength of a lease

if the parent corporation is not liable for the payments. The difference between the strength and staying power of an individual franchisee and a large, national corporation could be significant. It is also essential for an investor to consider tenants protected or benefiting from a more difficult or volatile economy. Tenants that provide irreplaceable or discounted consumer necessities are typically better positioned to weather difficult times. The net-leased property market is diverse and provides a broad array of tenant options for a client to customize their investment portfolio.

4. **Lease:** Information pertaining to selecting the right lease is provided in greater detail in the article “Analyzing Lease Terms,” which should be included in your packet. If you have received this article independent of the packet, please let us know and we will forward you the additional articles. In summary, the right lease requires a lease term long enough to provide stability, set with regular, contractually obligated increases in the rent (“lease bumps”), and free from unfair early termination clauses and renewal options.

5. **Ownership Structure:** With regard to ownership structure, please read “Real Estate Ownership Types” (and feel free to let us know if you need a copy). We recommend fee simple ownership as well as leased fee ownership. The investor should own the land and the improvements or just the land itself, rather than owning only the improvements on a ground lease (leasehold interest ownership).

As you search for investment solutions through net-leased property, keep these five aspects of net-leased investments in mind. A tremendous number of bad investments are out there—and many of them may appear fairly attractive. While all real estate purchases involve trade-offs, being equipped to know what to look for has helped us filter out the poorer-quality investments so that we are able to recommend suitable investment selections to meet our clients’ needs.

ANALYZING LEASE TERMS: WHAT YOU SHOULD LOOK FOR IN A LEASE

In addition to securing the right type of tenant, a sufficient lease term and the right lease structure, the terms of your lease protect your rights and the value of your asset over the long run. The lease terms described in this section are not unique to net-leases—they must be considered for any type of lease, including office, retail, industrial, and any other type of real property that has a longer-term lease attached to it.

Obligations: In any type of lease structure, it is important to understand the obligations of the tenant vs. the landlord. The obligations for both parties are essential to the proper administration and valid enforcement of a lease. For instance, if the landlord is required and fails to carry a certain level of insurance, the tenant may have the right to cease making rent payments or terminate the lease altogether. If the maintenance of the common areas of a property (shared by several tenants) is the landlord's obligation, certain leases may provide liability against the landlord if a failure to maintain common areas causes injury to a customer or employee or damage to a tenant's equipment or property. Each lease is unique and requires the landlord to fully understand the responsibilities of each party involved in the lease.

Liabilities: With any lease, it is important to ensure that your tenant's space and business are their responsibility. Typically, if you are the landlord, you will bear some structural risk, should something happen on your property that causes someone harm. However, do not allow operational risk of the tenant's business to fall back on you. We recommend that your lease include clauses that hold you harmless from any operational risk related to your tenant's business. General tenant risks may include use of any physically or environmentally hazardous materials, work-related injuries, business-related lawsuits, or damage caused to a tenant's furniture or fixtures (the decorations, shelf space, inventory, signage, etc. a tenant places in and around their space) in the course of their operations. This is not a comprehensive list of liabilities, but we can furnish you with a more complete list that is located in most primary lease templates.

Lease Bumps: Unless you buy a long-term net-leased asset with an incredible discount to market price, it is essential that you look for a lease that includes contractually obligated increases to the lease payment throughout the lease term and in the lease options. These contractual increases in rent are called "lease bumps" and can make the difference between a good and bad investment.

The primary reason why lease bumps are necessary is to offset inflation. Each year, the dollar continues to lose more of its value and buying power. It is important that your rent payments are increasing so that the value of your income and your asset rise with inflation. Think of the difference between what $100 buys today vs. what it would have bought 50 years ago, 20 years ago, or even 10 years ago!

Now, think of a rent payment fixed at $30,000 for the past 20 years. Not only would the purchasing power be diminished—the asset would have had a very difficult time appreciating without an increasing income stream. If the lease payment increased by 1% annually for the past 20 years, it currently would be $36,605, a 22% increase over the original lease payment. The increased lease payment would translate into higher prices for the resale of the asset. We typically encourage our clients to target an average of at least 1–2% rent bumps per year, depending on the quality of the tenant.

Renewal Options: Renewal options give the tenant the right but not the obligation to renew their lease for specified terms and rates upon the expiration of their initial, fixed term. Properly structured renewal options give value to both the tenant and the landlord, as they provide a tenant surety of what their future rent costs will be without directly obligating them. They provide the landlord prior notice of a tenant's intentions of renewal before the lease term is up. This arrangement allows both parties to prepare for their longer-term obligations and needs. If the tenant renews, the landlord and tenant know exactly what their income and costs will be, respectively. If the tenant does not renew, the process can give the landlord enough time to try to find a replacement when the tenant's initial term expires.

Not all renewal options are created equal. A common example of the type of renewal option to avoid is the option

structure typically associated with Walgreens' leases. Walgreens' leases can look initially attractive, with 15–25 years or more on the initial term. However, they then will attach 2 or 3 additional renewal options of 25 years to the initial term WITHOUT lease bumps. Regardless of the strength of the tenant, this means that the landlord could be stuck with 50–75 years of the same lease payment. This option is not only a poor hedge against inflation, but it greatly reduces your ability to resell the asset to a buyer for any profit in the distant future because the buyer will not want to be locked into the long-term nature of the fixed lease payments.

We encourage our clients to seek renewal options that total 5–15 years. In some circumstances, we have advised our clients to accept longer renewal options if the renewal options are favorable to the landlord, with sufficient increases in the rent obligations for each renewal period. Rent bumps must be sufficient over the lease term AND the option renewal periods to protect the investor from inflation and provide him a better chance of appreciation throughout the property's hold period.

Notice: Leases that require renewal or termination notices give landlords a cushion of time to know whether a tenant is renewing or prepare for a tenant's departure if they do not renew.

Notice requirements oblige the tenant to make their intentions known typically 6–18 months prior to the end of their lease. The ability of a tenant to take advantage of options is often tied to notice requirements so that the tenant is motivated to make a decision ahead of time. Some notice requirements include penalties if a tenant does not give sufficient notice to the landlord according to the lease agreement.

Early Termination Options: Some leases include early termination options. These clauses allow a tenant to give notice within a specified timeframe and legally terminate a lease before their initial, fixed term is complete. Most early termination options will require a tenant's prior notice 6–18 months before the termination goes into effect and require an agreed-upon lump sum payment by the tenant in order to effect the termination. The lump sum payment helps offset the landlord's costs in finding a replacement tenant. It is smaller than a tenant's entire lease obligation, should they have remained in the lease for the full term.

We encourage clients to avoid leases with early termination options—especially given these current market conditions. Most tenants who are lucky enough to have their fixed lease terms expire during or not long after a recession can take advantage of a soft rental market to cut their costs and negotiate significantly lower lease payments. We believe that it is important for our clients to be able to bridge difficult leasing environments with long-term leases that are fixed and free of any early termination options.

Co-tenancy Clauses: Co-tenancy and other types of conditional "out" clauses can provide a back door for your tenant to get out of their lease. A co-tenancy clause allows a tenant to "go dark" (i.e., cease operations at that location) or terminate their lease if another major tenant located adjacent to their space "goes dark" or files for bankruptcy. For instance, a CVS located within a grocery-anchored shopping center may reserve the right to halt rent payments, shut down operations at your location, or even terminate their lease with you, should the grocery store that anchors that shopping center stop operations or go out of business.

Another type of co-tenancy clause allows a tenant to be freed from the obligations of their lease if a tenant in the same or similar type of business is allowed to take space in the same shopping center or directly adjacent to the original tenant. In other words, Pizza Hut would attempt to limit the ability for another pizza company, like Domino's, to move in right next door. These clauses give tenants protection and competitive advantages in their specific locations. The tenants can enact their right to terminate their leases if those clauses are employed. While these types of clauses are common in normal leases, it is important to be aware of and analyze the probability of such clauses being enforced.

Tenant Buyout/Sublease: A landlord must control the terms of use of the space they are leasing. Even though a tenant may have rights to use a property under a long-term net-lease, they typically are not allowed to make material changes to the way they use their space without the prior permission of the landlord. This allows the landlord to control, on a general level, the types of businesses and uses of their property. For example, if a discount clothing company bought out Rite Aid, generally, they would not be able to simply turn all of their Rite Aid locations into clothing warehouses. They would typically have to

maintain the original business on the leased premises under which the lease was written. A properly written lease will require that the tenant receive prior written permission from the landlord to materially change their business operations in their leased space.

UTILIZE A PROFESSIONAL

Though these are some of the primary aspects of a lease that you should understand and look for, this list is not fully comprehensive. Each tenant and lease is unique. There is always the risk that a tenant includes clauses that are unfavorable to the landlord or open the landlord to risks beyond their control. Seek professional counsel to review the full lease terms before finalizing a lease agreement or purchasing an asset with a lease in place.

PRIMARY TYPES OF SINGLE-TENANT NET-LEASED PROPERTIES

This article provides a general description of the primary types of single-tenant net-leased assets investors encounter in the market and outlines a road map of the trade-offs of each asset type. These are general guidelines. A customized evaluation will be implemented when you build a portfolio in this asset class. Credit ratings may apply to parent-backed, corporate leases. Ratings listed are current as of 2017 or 2018; these ratings may change over time.

Whether you are looking for a net-leased investment to complete a 1031 exchange or simply to build a longer-term stable income portfolio, it is important to choose the right tenant, location, and lease structure. Given the fragile nature of our current economy, make sure that your tenant is in the right industry and business to be able to weather or even excel in the economic storm.

In order to help clients make informed investment decisions, we provide investors with property lists and advisory services tailored to their investment objectives and needs. Additionally, we have created tenant lists that include many major companies within each of the categories listed below and in other categories not included in this article. Please contact us if you would like more information.

NECESSITY RETAIL

Necessity retail primarily includes drugstores, pharmacies, grocery stores, and smaller convenience stores. These net-leased properties often provide the good mix of stable, corporate- backed tenants and necessity retail inventory that consumers require, regardless of the economic circumstances. Consumer necessities such as food and medicine are typically least affected in an economic downturn; thus, the stores that inventory and sell those items tend to remain fairly stable.

Typical Lease: Many necessity retail net-leased assets are tenanted directly by the parent corporations. Corporate-backed leases are more regularly encountered in this type of net-leased space than in the other categories. Most lease structures are initially at or in excess of 10 years, and there are many necessity retail corporations with investment-grade credit ratings. Long-term, stable leases may be found in the necessity retail net-leased space. However, necessity retail leases can often provide the tenant with extremely favorable renewal options—sometimes extending beyond 40– 50 years—without adequate “lease bumps.”

“Best in Class”: While Walgreens can provide a very strong lease with a corporate credit rating of BBB, it also has a lease structure without “lease bumps.” Walgreens leases are the usual suspects for these types of overly tenant-friendly renewal options. A Walgreens lease term may be from 25–75 years without significant lease payment increases. CVS leases are now structured very similarly to Walgreens and no longer provide regular lease escalations in the primary term or even in the option periods. They typically include long-term renewal options with due increases in the lease payments. CVS has an investment-grade credit rating of BBB.

A 7-Eleven location that is corporate backed will carry an investment-grade rating of AA-. There are also many grocery store conglomerates that carry an investment-grade credit rating. The purchase price of these larger grocery store anchor assets may be prohibitive to individual owners who wish to be diversified into multiple assets, so for most investors, Walgreens, CVS, and 7-Eleven assets may be more accessible in this particular category.

FAST FOOD RESTAURANTS

Fast food restaurants tend to do relatively well in both good and bad economic times. When the economy suffers, fast food traffic tends to remain stable. Many chains highlight discounted menu items, and consumers attempt to eat more inexpensively by switching to fast food from healthier foods that may carry a higher price. Many families adjust from “going out” at a nice, sit-down restaurant to “going out” for fast food when budgets get tighter. Investors should target well-known, national chains that regularly offer a “value” or “discount” menu for consumers.

Typical Lease: Most fast food net-leased assets are tenanted by regional franchise owners rather than the parent corporations. While franchise cap rates may be

much higher, providing a higher cash flow to the investor, the credit risk can be increased considerably when the corporation is not backing the lease. Corporate-backed leases are often more expensive and may have shorter lease terms than franchise-backed leases. However, multiple-restaurant franchise owners tend to run more profitable locations than corporate-backed leases and carry more favorable lease terms.

Investors deciding between franchise-and corporate-backed leases must take into account the location, lease terms, profitability of the restaurant, and overall success of the brand—both nationally and locally.

"Best in Class": Leases backed by the McDonald's corporation can provide a stable investment since McDonald's has a corporate credit rating of BBB+.

KFC, Taco Bell, Pizza Hut, and Long John Silver's brands are owned by YUM! Brands, and many of these restaurants are corporate backed. YUM! Brands' corporate credit rating is BB.

It should be pointed out that the chains listed above have both corporate-backed and franchise-backed locations—so it is important to distinguish between the guarantors of the leases when looking for potential investment

Strong franchise-backed options exist in many locations and within most major brands. We work with institutional real estate firms that specialize in building portfolios of fast food, fast casual, budget dining, and quick-service-style restaurants.

Pei Wei, In-N-Out, and White Castle chains are owned by private firms that typically do not franchise. These fast food or quick service chains also can provide a strong lease option because their parent corporations stand behind the lease and typically have little debt. Though there are always exceptions to the rule, it is often best to avoid fast food restaurants backed by corporations with credit ratings less than investment grade—indicating current or future financial weakness—or backed by single- or limited-location franchise operators.

DOLLAR STORES/DISCOUNT RETAILERS

Dollar stores and discount retailers tend to perform well in difficult economic times, as consumers are geared towards buying "on sale" or "reduced price" items. Discount stores serve consumer basic needs of food, clothes, and home goods, and some brands provide "higher-end" retail goods at wholesale prices. Discount stores perform well during economic distress because consumer mentality trends towards thrift and savings—and because wholesale inventory becomes less expensive to acquire as production demand decreases and other stores liquidate their inventory or go out of business. This perfect storm of cheaper inventory and increased consumer demand allows most discount retailers to widen profit margins and increase earnings.

Typical Lease: Most discount retail locations are corporate-backed leases with initial 10–20- year terms that include multiple renewal options thereafter. Lease bumps range from 0% until renewal options to as high as 1–2.5% per year. Most leases are double-net or triple-net, shifting the majority of the ongoing costs to the tenant rather than the landlord. With some leases, landlords participate in a small percentage of sales revenue above a certain base rent. Depending on the success of the store, revenue sharing can provide additional upside to the discount store investor.

"Best in Class": Discount stores provide investors with a larger selection of tenants that maintain an investment-grade credit rating. Ross (A-), Kohl's (BBB-), and Big Lots (BBB) are some of the strongest tenants, each with an investment-grade credit rating and a strong track record of good performance in both good and bad economic times. AJWright, T.J. Maxx, and Marshalls are all owned by TJX Companies, with an A+ credit rating. Costco (A+), Wal-Mart (AA), and Sam's Club (AA, owned by Wal-Mart) are much larger discount and wholesale retailers that can provide exceptional stability for those clients who can afford the higher prices.

Dollar stores provide investors with smaller-footprint, standalone locations that are often much less expensive than the discount store locations. Unlike the discount retailers, none of the major dollar store tenants maintain an investment-grade credit rating.

There are four major corporations in the space: Family Dollar, Dollar Tree, Dollar General (BBB), and 99 Cents Only. The rest of the dollar store space is filled with individual or limited- location franchises or much smaller, private corporations. Should a client invest in the dollar store space, Dollar General, Family Dollar, and Dollar Tree are the strongest options in terms of credit and national presence. Family Dollar is now owned by Dollar Tree which is rated BBB-. Dollar General is rated BBB.

GAS STATIONS

Gas stations perform relatively well in any economic circumstance, as they provide an inflation-hedged, necessity-driven commodity. While gas consumption may decrease in an economic downturn, it tends to maintain a level of demand that supports the operating costs of the standalone store location. The convenience retail business of gas stations (the food and beverages) drives additional profits for particular locations. Gas stations have large selections of investment-grade-credit tenants. Individual locations also can be backed by individual franchise owners.

Typical Lease: Gas station leases are typically 5 to 12 years in length with many shorter renewal options thereafter. The leases are shorter than those in other retail asset classes to ensure that the fixed costs of the lease are sustainable by commodity prices in the long run. Lease bumps range from 1–3% per year, and some leases are tied directly to (Consumer Price Index). Though it is often standard in the lease structure, it is essential for you to confirm that the corporation delivering the fuel is responsible for all environmental liabilities associated with the transportation, refilling, and storage of the fuel at the individual location. Corporate-backed leases are preferable to take advantage of the strength of the corporate balance sheet in the case of a short-term drop in commodity prices that might otherwise affect smaller, regional franchises.

"Best in Class": ExxonMobil has an investment-grade rating of AA+, while Shell has a credit rating of A+. Chevron, Texaco, ConocoPhillips, BP, and ARCO all have credit ratings of A-. ARCO is sometimes located in poorer neighborhoods, as they provide discount-priced gasoline if customers are able to pay by cash or debit. Phillips 66 and Union 76 have a credit rating of BBB+ and Valero is rated BBB. Each of these corporations can provide a strong tenant and a good, longer-term investment if the lease parameters are set up appropriately.

BUSINESS/COMMUNICATIONS

Corporations that provide business/communications services can be another source of stability through economically volatile times. Cell phone, landline, internet, and satellite services deliver both consumer and business needs that remain relatively stable. National, private-sector mail carriers often have strong credit ratings and may offer retail and distribution facility locations to meet investors' needs.

Typical Lease: Communication and mail carrier tenants usually offer leases of 10–20 years with extended 5-year renewal options thereafter. Most leases are net leases and provide modest lease bumps throughout the lease term. Most major brand locations have corporate-backed leases with few franchises available.

"Best in Class": UPS offers the highest credit rating of this category of net-leased properties with a credit rating of A+. Verizon and AT&T both have a credit rating of BBB+. FedEx and Kinkos are both owned by the FedEx Corporation, which has a credit rating of BBB. Each of these corporations may provide stability within the lease term. Most AT&T and Verizon locations support fixed lease terms of 10 years with renewal options thereafter, and they choose higher-profile, high-traffic locations that can be easier to fill, should the primary tenant choose not to renew. UPS and FedEx often have longer original lease terms, but they do not always select the most heavily trafficked areas. T-Mobile has a credit rating of BB+ and has underperformed against AT&T and Verizon in the U.S. as a cell phone carrier and may not be an ideal tenant choice for longer-term stability.

DISCOUNT AUTOMOTIVE

Businesses that provide vehicle repairs, tune-ups, fluid changes, and parts are common tenants in NNN properties. Unlike other categories of net-leased properties, corporations that provide vehicle repairs or parts do not all benefit from market downturns. Discount automotive part stores may do well in harder economic times as consumers are forced to attempt self-repairs that otherwise would have been handled by dealers or independent mechanics. However, as automobiles have made technological advances in the last decade, it has become more difficult for consumers to self-repair mechanical or electrical problems. It is important to select businesses that provide automotive goods and services that are ongoing with tenants backed by investment-grade corporations.

Typical Lease: Vehicle-related tenants typically provide leases with terms from 10– 20 years that are NN or NNN in structure. Renewal options of 5 years or more are common in the original lease. Lease bumps are often 1–3% per year. Due to obsolescence factors, especially for those businesses that provide parts, it is important for investors to ensure that they are participating in corporate-backed

rather than franchise-backed leases. The landscape of vehicle repair and parts stores is filled with franchises, so it can be difficult to locate the right type of tenant. As with gas stations, environmental issues may arise with vehicle service facilities. An investor must ensure that these liabilities fall entirely on the corporation providing the service within the lease.

"Best in Class": Autozone, Advance Auto, and O'Reilly's are the only auto parts stores that are rated investment grade and are the primary tenants that we would recommend from a credit perspective. NAPA Auto Parts locations may carry a partial liability guarantee from GPC, and can also be an option for net-leased investors in the discount automotive space. Jiffy Lube, owned by Shell Oil Co. (which has a credit rating of A+), provides an ongoing service that consumers require, regardless of the economy's health. Jiffy Lube can be a strong investment if the location is backed by the parent corporation, and explicitly obligates the parent corporation for any future environmental issues associated with their operation.

CASUAL AND BUDGET DINING

Casual and budget dining restaurants may perform similarly to fast food restaurants. They seek to provide the consumer with inexpensive meals and a cheaper way to "go out." However, casual and budget dining chains vary significantly in their overall performance. Investors must be selective in this asset class, as many chains have struggling parent corporations and, as with fast food, certain locations are better managed by franchise operators than the parent company.

Typical Lease: Most leases in this space are 15–20-year triple-net leases with renewal options tied to the end of the fixed term. Lease bumps tend to be at least 1–3% per year. In most major restaurant chains, there are both franchise and corporate-backed locations.

"Best in Class": Olive Garden, LongHorn Steakhouses, Eddie V's, Cheddar's, etc. are all owned by Darden Restaurants, which has a credit rating of BBB. Companies like Denny's and IHOP have also performed relatively well, but the parent corporations have below-investment-grade credit, and their individual locations tend to be better managed by larger franchise operators.

INVESTMENT-GRADE NET-LEASED OFFICE

Investment-grade net-leased office includes corporate headquarters, distribution facilities, and service locations of large companies with strong, investment-grade credit rating that do not typically operate in retail shopping locations. Examples include healthcare companies, pharmaceutical companies, technology providers, business-to-business services, consumer goods manufacturing facilities, etc.

Typical Lease: These leases vary but typically include lease terms in excess of 10 years with a number of predetermined renewal options. Lease bumps tend to be small (1–2% per year) or flat, depending on the importance of the location.

"Best in Class": Healthcare providers and pharmaceutical companies with investment-grade credit ratings are often the best tenants to have in net-leased real estate. Like food and gasoline, healthcare and pharmaceuticals are ongoing necessities that consumers utilize throughout difficult economic times. Corporate headquarters of major healthcare and pharmaceutical companies are preferred.

UPDATED PROPERTY PROVIDERS AND TENANT LIST

Please feel free to contact us at info@jrwinvestments.com or by phone at (877) 579-1031 if you would like us to send you custom property lists as well as comprehensive tenant information lists. Tenant information lists include the parent corporation of most major retail tenants, whether or not they are public, their corporate credit rating, whether or not they are regularly franchised or backed by corporate leases, and the number of locations they have throughout the country or the world.

IMPORTANT DISCLOSURES

Diversification does not assure a profit or guarantee against the potential loss of your investment.

Risks associated with investing in Real Estate include, but are not limited to, the following: cash distributions are not guaranteed; real estate is illiquid; risks associated with owning, managing, operating and leasing commercial real estate property; conflicts of interest among the asset management, the property manager and associates; the possibility that the property may be overleveraged; tax risks; interest rate risks; economic risks; risks of terrorism; environmental risks; liability risks; zoning, city ordinance, and or legal compliance risks; title and escrow risks; flood risks; fire risks; credit risks; and risks of obsolescence.

1031, 1033, and 721 Exchanges: Substantial fees and expenses could be incurred and there are strict timing limitations (for example, if the transaction is not properly constructed and executed in a timely manner, then an investor may lose all tax benefits of such transaction and may also incur taxes associated with depreciation recapture.). 1031 and 1033 exchanges involve exchanging investment real estate for investment real estate, and thus the illiquidity from one transaction to the next remains the same. 721 exchanges involve exchanging real estate for units in an operating partnership generally associated with a Real Estate Investment Trust (REIT). If the operating partnership units are not publicly traded, then the transaction may have resulted in greater diversification, but the same level of illiquidity. If a 721 exchange is not executed properly, it could result in a loss of tax deferral and a recapture of depreciation. Ultimately, 1031, 1033, and 721 exchanges generally involve exchanges into additional investment real estate or operating units that are collateralized by investment real estate and are thus subject to the same risks that apply to real estate.

Risks associated with investing in a Delaware Statutory Trust (DST) or DST private placement transactions include, but are not limited to: the inability of the DST owners to actively manage the property, inability to refinance at the end of a loan term without the use of a separate, springing LLC, and the risk of not meeting requirements for 1031 or 1033 exchange tax treatment. Additionally, DST private placements are ultimately collateralized by real estate and are subject to the same risks that apply to real estate.

Risks associated with investing in a Tenant-in-Common (TIC) or TIC private placement transactions include but, are not limited to: the inability of the TIC owners to actively manage the property, potential difficulties with refinancing at the end of a loan term without the use of a separate, springing LLC, and the risk of not meeting requirements for 1031 or 1033 exchange tax treatment. Additionally, TIC private placements are ultimately collateralized by real estate and are subject to the same risks that apply to real estate.

Risks associated with investing in Non-Traded Real Estate Investment Trusts (REITs) and Real Estate Funds include, but are not limited to: the inability of the REIT shareholders to actively manage the properties in the REIT, illiquidity until an exit or public event (which may not happen and is not guaranteed), risks associated with management and investment banking execution, etc. Additionally, non- traded REITs are ultimately collateralized by real estate and are subject to the same risks that apply to real estate.

Alternative investments and private offerings involve a high degree of risk, can be highly speculative, and may result in the loss of principal invested and are not suitable for all investors.

Securities offered through Lighthouse Capital Group, LLC Member FINRA/SiPC.

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DST, TIC, and real estate investments are speculative and require a high level of due diligence. The firm's due diligence performed does not guarantee investment performance. Each investor should perform their own research and understand the details and risks involved prior to making an investment. IRC Section 1031 is a complex tax concept; therefore you should consult your legal or tax professional regarding the specifics of your particular situation. There are material risks associated with investing in real estate. Some include loss of principal, declining market values, and tenant vacancies. Real estate investments are typically illiquid investments. Past performance is not a guarantee of future results.