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I'm a Landlord: Can I Ever Truly Retire?

Investing in rental properties is a time-tested strategy, but when you're ready to get out of the grind, you could face a big tax bill. Here's one escape route.

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There is a major dilemma facing many Baby Boomer investors today. Their successes in real estate have produced a failure in quality of life. What is the problem, and is there a solution?

Let's start with the problem: a "good problem" to have. Twenty to 40 years ago, you bought rental real estate, maybe a small apartment complex or several rental houses. This can be a great strategy to build wealth for someone in their earlier years of investing. But as I advise my own clients, owning actively managed real estate is best for a season of your life, but not for the duration of your life.

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

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

Section 1031 of the tax code allows for tax-deferred exchanges of properties where you can sell your real estate, then identify and close on replacement property in 45 and 180 days respectively. The problem with this solution is you still would own real estate you have to manage in your later years. Can you exchange tax free into a real estate partnership, real estate LLC, publicly traded REIT or private REIT? The answer is no to all of these.

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

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

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

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

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