HEALTHCARE REAL ESTATE ADVISORS

SPECIAL REPORT

PRACTICAL TAX CONSIDERATIONS WHEN ASSESSING A SALE OF YOUR PRACTICE REAL ESTATE

"While there are a variety of benefits associated with a sale and leaseback, many of the tax advantages are less clear. Our goal with this report is to highlight a few of the more apparent tax benefits and how you can leverage them."

Collin Hart, CEO
ERE Healthcare Real Estate Advisors

LETTER FROM THE CEO

With the continued consolidation in healthcare and acceleration of telemedicine, its clear that the way our clients practice medicine will be different 5-10-20 years from now. As you think through your succession plan and personal investment objectives, a sale and leaseback of your practice real estate may come to mind.

While there are a variety of benefits associated with such a transaction, many of the tax advantages are less clear. Our goal with this whitepaper is to highlight a few of the more apparent tax benefits and how you can leverage them.

As usual, if we can be of service in strategizing on or exploring a potential real estate transaction, please do not hesitate to reach out to one of our advisors.

Warm regards,

Collin Hart, MBA
CEO & Managing Director

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By Jamion Nash, Financial Analyst
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SPECIAL REPORT

PRACTICAL TAX CONSIDERATIONS WHEN ASSESSING A SALE OF YOUR PRACTICE REAL ESTATE

By Jamion Nash
ERE Healthcare Real Estate Advisors

After serving their patients, most of our physician clients have the mindset of creating a secure future for their families by slowly compounding their wealth. To help realize this goal, many of them have the opportunity to invest in their practice or ASC real estate, creating a stream of passive income in the form of rent payments from their operation. When discussing succession plans with our clients, we consistently hear their desire to maintain this passive income into retirement. While there are a variety of risks and conflicts that can arise from continuing to own your practice real estate post-retirement, we won't focus on those in this whitepaper. Instead we've attempted to highlight three tax advantages/strategies that may positively impact physician real estate owners. Leveraging this knowledge, we hope to help our clients achieve the highest possible returns on their practice real estate investment.

THE TIME VALUE OF MONEY

Before discussing taxes, we'll address the time value of money. The concept is that a dollar today is worth more than a dollar 1-3-5-10 years from now. In practice, if you have a dollar now and can invest it to generate a return, you will have grown that dollar to a higher value versus receiving the same dollar five years from now.

This applies to our clients who enjoy the passive income they receive as rent. While the future rent payments appear attractive, if the income stream could be monetized for a large multiple through a sale and leaseback transaction, allowing the practice to continue operating uninterrupted, would it not make sense to capture the next 13-15 years' worth of rent payments today?

ADVANTAGE 1
ORDINARY INCOME VS CAPITAL GAINS

When comparing the financial implications of a sale versus collecting rental income, it's important to consider how the income will be classified by the IRS. Rental income, while offset by deductions such as mortgage interest and depreciation, still flows down to the personal tax returns of the partners. As a result, the income is taxed as ordinary income. Under the 2018 Tax Cuts and Jobs Act, income requirements were modified, lowering the tax brackets for many high-income earners. According to the 2019 Physician Compensation Report published by Doximity, family medicine and pediatric

A DOLLAR TODAY IS WORTH MORE THAN A DOLLAR TOMORROW

"A sale and leaseback transaction allowed my clients to: 1) obtain a higher price for their real estate investment, 2) reduce their concentration of risk in a single asset and 3) deploy their sale proceeds into other investments to help diversify their investment portfolio and increase their cash flow."

William D. Heichel, JD, CFP® | Founder & Chairman of the Board
Pinnacle Wealth Planning Services, Inc.

providers earn an average of $215,034 per year, placing them in the revised 35% tax bracket. Specialists tend to earn significantly more, including those practicing orthopedics, dermatology, ophthalmology, and gastroenterology, elevating them to the top federal tax bracket of 37%. The takeaway is that physicians already face a heavy tax burden, so adding rental income to the mix is not necessarily tax efficient when other options are available.

Tax Rates

Income	Ordinary Income	Capital Gains
$0	10%	0%
$9,875	12%	0%
$40,125	22%	0%
$85,525	24%	15%
$163,300	32%	15%
$207,350	35%	15%
$518,400	37%	20%

Source: https://taxfoundation.org/2020-tax-brackets/

In a sale and leaseback transaction, profits from a sale are taxed as a long-term capital gain (provided you have owned the property more than one year), which reduces your tax rate to 15-20% on the gain (not the entire sale price), resulting in higher tax efficiency. Not only are you securing the next 13-15 years' worth of rent, but you're also paying one half of the taxes. Of course, several factors must align, including the timing of your partnership, your practice's continued utilization of the facility, etc., but the opportunity to net higher proceeds than your forecasted rental income is very real.

TAX ADVANTAGE 2
THE 1031 EXCHANGE

While the concept of paying less taxes is appealing, we have many clients who recognize the opportunity of a sale and leaseback, but don't need the liquidity now and prefer to defer taxes from a sale. Although common in the world of investment real estate, many physicians are unaware of Internal Revenue Code Section 1031, also known as a 1031 Exchange. This provision allows a real estate owner to "trade" property that was held for investment for another property that will also be held for investment. 1031 Exchanges benefit from three distinct advantages which sellers may consider as a part of their succession planning strategy:

DEFER TAXES

Perhaps the largest and most widely known benefits of a 1031 Exchange is the ability to defer tax liabilities from sale. By utilizing an exchange, you are able to defer the payment of your income tax liabilities, keeping 100% of your cash working for you through reinvestment into other real estate assets; this could be a new surgery center, a 2nd "investment" home, or another real estate asset. Tax deferral and tax exclusion strategies can help to reposition or rebalance a real estate portfolio or help accomplish any number of financial, tax or estate planning strategies.

PORTFOLIO GROWTH

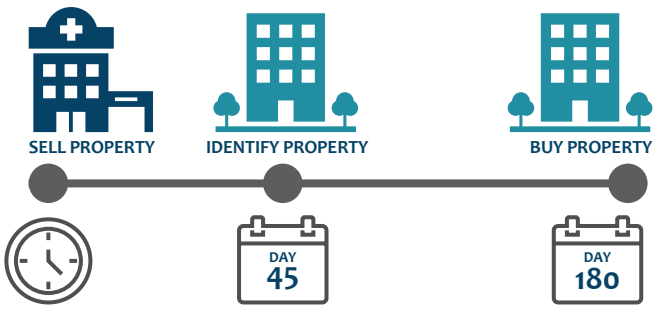
Instead of selling a property, paying taxes, then reinvesting the net after-tax proceeds, a 1031 Exchange provides the opportunity to reinvest 100% of your sale proceeds, pre-tax. For example, if you were to sell and leaseback your facility for $7,500,000 without utilizing a 1031 Exchange, you could pay hundreds of thousands (depending on your basis) of dollars to the government. After paying the IRS, let's say your investable capital is hypothetically reduced to $6,500,000. But leveraging a 1031 Exchange, you have the opportunity to reinvest the entire $7,500,000 into other investment properties.

As you continue to invest over time, the value and number of your real estate assets is likely to grow. By exchanging up in value or from single to multiple properties and deferring the capital gains, depreciation recapture, and income tax liabilities, your net worth will grow faster over your lifetime.

STEPPED UP BASIS

Continued real estate ownership through a 1031 exchange also provides the benefit of your heirs receiving a step up in basis. In simplified terms, your basis in a property is equivalent to your purchase price. When your assets pass to your descendants, their tax basis is computed at the then market value, likely higher than what you purchased it for because of long-term appreciation. This benefit serves to reduce the burden of capital gains for your heirs, allowing them to sell with limited tax consequences, or continue owning the property and collecting passive cashflow.

1031 Exchange Timeline



TAX ADVANTAGE 3

UPREIT TRANSACTION

For those physicians interested in capitalizing on a real estate sale and taking advantage of favorable tax treatment under a 1031 Exchange, but uncertain of what property they should exchange into, another option exists: an UPREIT transaction.

An UPREIT or "Umbrella Partnership Real Estate Investment Trust," is an often-overlooked investment solution where an owner executes a sale and leaseback transaction with a real estate investment trust ("REIT"), but instead of taking all of their sale proceeds as cash, takes shares of the REIT. Property-for-share exchanges in an UPREIT transaction are generally allowed under Section 721 of the Title 26 Internal Revenue Code, giving them similar tax deferral benefits as a 1031 Exchange.

While the idea of deferring taxes on a sale is attractive, there are additional benefits associated with an UPREIT transaction. Because you now own shares of a REIT, you're entitled to the dividends they pay on a monthly or quarterly basis. Depending on the REIT who acquires your property and at what share price, your annual dividends can range between 3.5% to 8%, creating an attractive replacement for the cashflow you relinquished in the sale of your property.

Another benefit of an UPREIT transaction is improved liquidity. Once in possession of UPREIT units (shares), owners can choose to sell all or a portion of their shares at their discretion. Should you need cash for a new business venture, investment property, or home, you can simply redeem or sell the shares on the open market at the prevailing market price. Of course, because taxes were deferred on the initial sale of your property, once you receive cash, the redeemed shares are subject to the taxes you deferred. Meanwhile, the shares you still own continue growing, tax deferred, and paying a dividend. As shares appreciate or shareholders require liquidity, they can simply sell their shares, creating additional potential gains as the share price appreciates.

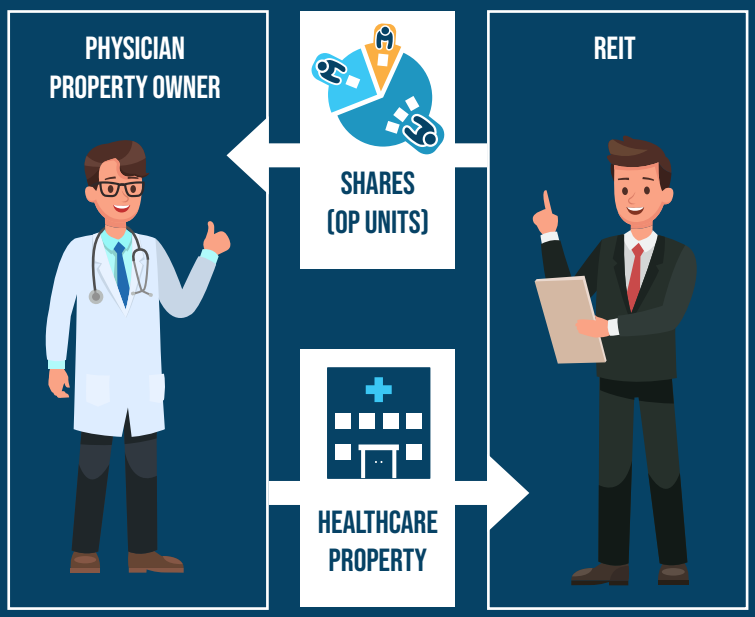
While not all REITs offer an UPREIT exchange program, the opportunity exists and provides a strategic solution that can allow physician partners to capitalize on strong pricing for their facility, diversify their investment holdings, defer taxes, and eliminate potential partnership conflicts that can arise in real estate ownership.

"Since our IPO in 2016, we have completed six UPREIT deals for a total of $120 million in purchase value and $30 million in OP Units.

We like offering physicians the option of exchanging their property for OP Units and we have developed a good track record completing these types of transactions. These physicians benefit from exchanging ownership of their property for equity in a $1 billion portfolio of health care facilities."

Alfonzo Leon
Chief Investment Officer
Global Medical REIT
NYSE:GMRE

UPREIT STRUCTURE



*The above diagram and ownership structure have been simplified for purposes of example.

YOUR GUIDE TO

SALE AND LEASEBACKS

HEALTHCARE REAL ESTATE

WHAT IS A SALE AND LEASEBACK?

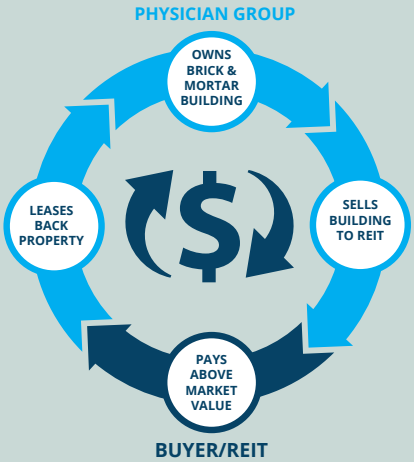
A sale and leaseback is a type of real estate sale in which a practice sells its property for cash and simultaneously executes a long-term lease with the buyer.

WHY A SALE AND LEASEBACK?

This gives physician-owners an opportunity to cash out of their real estate investment while the market is at a peak, but allows them to continue operating long-term, uninterrupted, and with full control of the building.

HOW CAN A SALE AND LEASEBACK HELP ME TODAY?

- With a long-term lease in place, your facility is marketable as a cash-flowing real estate investment.
- Valuations for cash-flowing healthcare facilities leased to best-in-class providers have reached historic highs.
- Monetizing your real estate investment at the top of the market may allow you to pay off debt, eliminate personal liabilities, and create liquidity for your partnership.



CONCLUSION

While there are a variety of benefits associated with selling and leasing back your practice real estate to alleviate partnership tension, simplify your recruiting discussions, or just take some chips off the table, there are also tax benefits that play into the equation.

Although these concepts may be less familiar to you and your partnership, they're common in the world of investment real estate and when properly leveraged, can bolster the already compelling value proposition of a sale and leaseback transaction.

With continued investment interest in the healthcare real estate sector, physicians who have properly educated themselves and evaluated their options are well positioned to capitalize on lofty valuations for their clinical and surgical real estate assets.

Even if a real estate sale doesn't meet your current objectives, addressing potential partnership challenges early will maximize the value and security of your investment.

HEALTHCARE REAL ESTATE ADVISORS

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