Deferring Capital Gains Taxes When Selling Property
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Capital Gains Deferral

Deferral of capital gains has received much attention over the last few years as property values have grown rapidly. Many tax experts will often advise their clients to just pay the taxes because the capital gains rates are the lowest they've been in years and are likely to go up in 2011. Advice such as this can be misplaced and may not be in the best interest of the property owner. Take a hypothetical case in which someone purchased a property 20 years ago for $250,000. Assume that the property has appreciated to $2,000,000. This appreciation represents a capital gain of $1,750,000. If the property is located in California, then that property is subject to federal capital gains taxes of 15% and state capital gains taxes of 9.3% for a total tax of 24.3%. This total tax of 24.3% is $425,250 leaving the client a net of $1,324,750. Additionally, if the property owner took depreciation over the 20 years, then that depreciation will be subject to as much as 34% recapture tax. For this example, we have assumed no depreciation.

So, when tax and investment professionals advise clients to pay taxes now, they fail to realize that the taxes paid may very well represent a very large and significant portion of that client's net worth. Many times the cash proceeds from a property sale represent a client's net savings for retirement and cutting that number by 20%+ can make a very significant difference in the quality of the property owner's retirement.

What are Capital Gains?

Capital gains taxes are federal and state taxes applied to any gain or appreciation, on an asset, above that asset's basis or purchase price. Current federal capital gains rates are at 15% and state rates vary from 4% to 9% bringing total taxes, in general, to roughly 20%-25%. Capital gains taxes are applied at the time the sale takes place which is when the gain is realized. The taxes must be paid in the year of sale.

The federal tax rate on long-term gains was reduced in 2003 to 15%, or to 5% for individuals in the lowest two income tax brackets. In 2011 these reduced federal tax rates will "sunset," or revert to the rates in effect before 2003, which were generally 20%.

Why Deferral of Capital Gains Taxes is Important

Most property owners understand the concept of time value of money and the importance of getting and keeping as much cash as possible in today's dollars so that you can invest those monies and allow for compounding or returns on that money over time.

This same basic concept of compounding can be applied to paying capital gains taxes and taxes on depreciation recapture. The key is to defer the payment of capital gains taxes and depreciation recapture for as long as possible in order to yield the maximum return on those tax dollars.

In our example above, if the property owner were able to take the $425,250 in taxes and defer that over 25 years, then the property owner would have actually ended up with more money than when they started. If we assume that this money could grow at 6% rate of return per year for a period of 25 years, then that $425,250 would have grown to over $1.8M.

Techniques for Deferral of Capital Gains Taxes

There are a number of techniques and strategies available to property owners to defer capital gains taxes.

Installment Sale

With this technique the property owner sells their property and holds a note for some amount of the sales price at a stated rate of interest for a stated number of years and a stated payment frequency and amount.

- *Pros:* This is a simple, low cost and easy method for deferring taxes.
- *Cons:* Risk of buyer default; foreclosure costs can be significant; property values can decline at time of foreclosure; property has been "run down" or degraded in some manner due to buyer negligence.

Structured Sale

This method requires that the buyer agree to an installment note with you as the seller. The buyer secures full financing for the property. The buyer agrees to assign their obligation to pay to an independent, third party assignment company. The assignment company agrees to make payments on behalf of the buyer. The assignment company invests the monies into an annuity. The annuity provides enough interest income to support the installment note.

- *Pros:* Simple to implement, low cost
- *Cons:* Difficult to get the buyer to agree to the concept of giving their monies to a third party; if buyer used debt financing, then buyer is dually obligated to the lender and the seller; interest rates on the note will tend to be low which means a low payout for the seller

Self Directed Installment Sale ™

This technique allows the property owner to transfer their property to a LLC. The property owner secures a buyer for the property. The property owner then sells the membership units of the LLC to an independent Trust on an installment basis. The Trust then has the property sold from the LLC and the buyer gives cash to the LLC. The Trust then starts payments to the original property owner.

- *Pros: B*uyer completes transaction in a normal manner; seller has note secured/collateralized with a cash investment inside the LLC versus using the real estate; seller does not have to worry about foreclosing on buyer seller does not have to worry about declining property values as a result of market conditions or buyer misuse;
- *Cons:* Requires setup fees and expenses

1031 Exchange

This involves the exchange of a current property with a new property. This is most typically accomplished through the use of an independent party known as a qualified intermediary (QI). The QI takes possession of your property, sells it to a buyer, and then the QI holds onto the cash proceeds until you find a replacement property. Upon finding a replacement property, the QI is

instructed to bring the cash to closing. Upon closing, the QI turns over the replacement property to you. This entire process has to take place within 180 days of selling the current property.

- *Pros:* Provides indefinite deferral of taxes; low cost.
- *Cons:* Difficult to find replacement properties; if replacement property is cheaper then taxes are due on the difference; difficult to complete transaction in 180 days; 20%-30% of 1031 exchanges will fail which requires paying all taxes in that tax year; does not provide a exit strategy from real estate; does not provide as good of an income stream as a series of payments.

1031 Rescue ™

This technique is a combination of a 1031 exchange along with a Self Directed Installment Sale™. Under this method the qualified intermediary agrees to handle your 1031 exchange with two conditions: 1) They will provide you with a replacement property if one is found, or 2) They will give you an installment note at the end of 180 days if no replacement property is found. The end result of this is that you can have a 1031 exchange without worrying about a failed exchange. If the exchange fails you will still receive tax deferral via the installment note issued by the QI.

- *Pros:* Guarantees deferral of taxes
- *Cons:* Setup fees; still have the issues with a 1031 exchange related to 180 days and ability to locate a replacement property.

Anyone who has been delaying the sale of their property because of taxes should re-think their strategy by considering one of the tax deferral techniques outlined above. Many of these strategies are very powerful and will leave you in better financial shape. You should also note that by being able to sell property tax deferred you are able to discount your properties sales price and recoup that discount through the deferral and compounding of the taxes.

The tax strategies that NAFEP provides are Self Directed Installment Sales (SDIS℠), Self Directed IRAs via a LLC (ICO℠), Self Directed 401(k)s (one.K℠), Cost Segregation Studies, 1031 Rescue and 1031 exchanges. For more information, please contact Jeff Reed at (888) 886-2337 or email him at jeff@nafep.com or visit the website at www.nafep.com/jeffreed.