

## **Sell High, Buy Low – TAX FREE!**

**By Carlo J. Sparacino**

With real estate values at or near historic levels, property owners who would like to sell, and realize their gains have a limited number of alternatives available. The most obvious solution for most investors is to sell their property and opt for a 1031 exchange. This is part of the reason why property values have reached their current levels. Many investors have their funds with an accommodator and they are having a difficult time locating a replacement property. This can lead to panic buying, as investors reach the end of their exchange time frame and are acquiring new properties purely to avoid the tax hit. By continuing this cycle investors are ignoring the fundamentals for property valuation.

The next logical step for most property owners, especially if they have not found their up-leg, is to go ahead and pay the capital gain tax. After all, capital gains taxes are at historically low levels. What we frequently hear from property owners is “With a low 15% capital gains tax, I’ll go ahead and pay the tax and be done with it.” But, do not forget to add on the 9.3% state tax, which now brings your tax liability to 24.3% for California residents. The unpleasant surprise awaiting many conscientious taxpayers is called the AMT tax (Alternative Minimum Tax). There is a complicated formula used to determine if AMT applies, and quite frequently AMT shows up as a last minute surprise tacking on an additional 4-5% tax liability. Suddenly, your tax liability is approaching 30%. And let’s not forget those fortunate pre-1987 property owners who took advantage of accelerated depreciation. Uncle Sam has a surprise for you. Any accelerated depreciation is recaptured at ordinary income rates. This can easily bring your total tax liability to 35-40%. This is the least desirable alternative as you can pay 1/3 or more in taxes even with the reduced capital gains rate.

The third alternative for many investors is to opt for a 1031 exchange to a Tenant in Common Project (T.I.C.). The challenge with a T.I.C. is to find the right project. With demand dramatically out pacing supply, it is more and more difficult to become a T.I.C. investor with the project you desire. We are in a market where when a PPM (Private Placement Memorandum) becomes available, there is frequently an overabundance of subscribers hoping to purchase a limited number of units available. This leads to the sponsors sorting through stacks of applications trying to decide which investors to let in. Fortunately, they tend to favor investors who are closest to the end of their 180-day window. This leads to the next problem. Several T.I.C. sponsors are committed to bringing more products to the market to satisfy the increased demand. In an effort to satisfy the market place, fundamentals can take a back seat to project selection and price negotiations. Sponsors may be overpaying for projects, which may subsequently have negative impacts for investors.

The fourth and final option for property owners is most frequently overlooked and in many cases can be the most favorable. That is the Private Annuity Trust. This involves a property owner creating a specially designed non-grantor trust. The trust sells the property with a stepped up basis, avoiding capital gains tax and depreciation recapture tax at the time of sale. The Private Annuity does not eliminate taxes, but rather defers them for long term, often for decades, and with no penalty or interest for doing so. The deferral takes place because the property owner receives his sale proceeds in a lifetime income stream from a private annuity contract. Capital gains and recapture taxes are paid as the income stream is received. If the annuitant lives to the exact life expectancy that the annuity was based on, the annuitant will end up paying all the capital gains on the sale. But the first payment may be ten, twenty, or more years after the annuity sale. Then the annuity payments spread the capital gains taxes over another ten, twenty, or more years. This means that the payment of capital gains taxes could be spread out over a total time span of as much as fifty years with no penalty or interest on the deferral. This allows the trust to use the entire cash proceeds, including the unpaid taxes, to invest in any worthwhile investment. The unpaid and deferred taxes remain in the trust to work alongside the rest of the sale proceeds to produce a much larger amount of income. *At the death of the second annuitant the trust assets pass to the designated beneficiaries, Estate and Probate Tax-Free.*

The tax and legal information on this statement is merely an overview of our understanding and interpretation of the current income tax laws and regulations, and is not extensive. This

information is general in nature and should not be construed as tax or legal advice. Please consult your tax and legal advisor for guidance regarding your particular situation before making any changes.

*For more details on the above topic please be sure to attend our upcoming seminar at the **AOA Van Nuys home office at 6445 Sepulveda Blvd., on Thursday, June 17<sup>th</sup> at 1:00pm-3:00am**. If you cannot attend this seminar or would like information sooner please contact Carlo J. Sparacino at T.E.A.M. Portfolio Advisors, Inc. at (800) 584-1535. Securities offered through SII Investments, Inc. member NASD, SIPC.*