FINDING THE CORRECT REAL ESTATE EXIT STRATEGY

By Eric Salant, Esq., Capital 1031 Exchange Company, LLC OCTOBER 17, 2014

Although real estate can be a fantastic long term investment, as with any investment, there comes a time when it is time to move on. It comes as no surprise that in some cases, the capital gains liability may otherwise discourage a transition out of real estate. Since our company is dedicated to helping you preserve your capital gains, we wanted to give you a comprehensive list of choices for sheltering capital gains liability when selling real estate.

1031 EXCHANGES

Most investors are aware that they can exchange real estate for other real estate and defer their capital gains, so long as they continue to own real estate. That is all well and good if the investor wants to replace their existing real estate for new real estate, and since there are no geographical limitations as to where they can replace, and very few restrictions on what type of real estate they can purchase, this has been a very popular choice for many investors. Our company has acted as a qualified intermediary in thousands of these exchanges helping many of clients defer their capital gains.

TRIPLE NET LEASE PROPERTIES

While a 1031 exchange is viable if the investor has specific replacement property in mind and has a desire to manage the property, a triple net lease property enables the investor to get away from active management and to often buy a high quality investment. Triple Net properties usually involve credit worthy tenants and long term leases. A few examples would be a CVS Pharmacy, an Applebees, or a WAWA. The upside on these transactions is that they have a guaranteed cash flow, the lease rate increases each year, and they tend to have terms exceeding 10 years. For those investors looking for a guaranteed yearly return and none of the hassles of property management, these are a viable option.

CHARITABLE REMAINDER TRUST

Like and Installment Sale Agreement, Charitable Remainder Trusts are also based upon a “money over time” concept. With a CRT, the investor receives lifetime monthly payments after transferring the asset to a trust. The asset is transferred to a trust and the charity is the entity that will inherit any funds once the investor dies. The main advantage of a CRT is that in addition to monthly cash flow and the satisfaction of one’s philanthropic objectives, the donor qualifies for a charitable income tax deduction, which is usually the present market value of the remaining interest to the charity. Additionally, if the deduction is not all used during the first year of contribution, it may be carried forward and utilized over five years.

TAKING ADVANTAGE OF IRS CODE SECTION 121

When a personal residence is sold, IRC section 121 allows for a capital gain tax exclusion of up to $250,000 if a taxpayer is single, and $500,000 if a taxpayer is married, as long as the residence has

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been owned and personally used by the taxpayer for an aggregate of two of the preceding five years before the sale. With the enactment of Rev. Proc. 2005-14, there is now a way to exclude gain in excess of the $250,000/$500,000 limits. For example, if a house was bought for $100,000 20 years ago, and it is now being sold for $1 million, the taxable gain is $900,000. Under the old law, taxes would be owed on $400,000 of gain. Under the new IRS rules, if a married couple first converts the house to a rental, they can exclude $500,000 tax free at closing under IRC Section 121, and then perform a 1031 exchange and buy another rental house for $500,000, to exclude the remaining $400,000 of gain!

Another way to take advantage of Section 121 involves exchanging a rental house for a rental house, holding the rental house for at least 2 years, and then moving in and making it a new personal residence. The house can then later be sold and taxes excluded under IRC Section 121 (with the exception of deprecation recapture) as long as the house is held for at least five years from the date of purchase through the exchange.

REAL ESTATE AS A GIFT

If you wish for your children to own a portion of your real estate while you are still alive, you can gift portions of the real estate to them each year in the amount of the annual gift tax exclusion (currently $13,000). Depending upon your financial position, this may or may not be a good plan, because a donee's basis from a gift is the same as the basis of the donor. Contrary to getting a stepped up basis at death, gifting prior to death may cause them to pay a far higher percentage in taxes.

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