Planning Your Exit: Strategies for Real Estate Investors to Mitigate Capital Gains

EXECUTIVE SUMMARY

For individuals who wish to sell appreciated investment real estate, there are a variety of strategies to mitigate the capital gains consequences. These include 1031 exchanges, in which one investment property is swapped for another without the recognition of gain. They also include variations on the traditional 1031 exchange as well as philanthropic strategies that can allow a taxpayer to defer or reduce the tax consequences of a sale while also benefiting a charity that's important to them. These all tend to be complicated solutions and it's important to consider them in the context of your own financial situation before deciding if any of them will work for you.

INTRODUCTION

People invest in real property for any number of reasons, from the sentimental to the practical to the innovative. The potential income streams and growth can be very attractive and very valuable. But many property owners focus on the short term benefits and don't plan for the long term hurdles, such as the tax consequences when the appreciated property is eventually sold. Planning your exit strategy in advance is the best way to ensure that a looming tax burden doesn't limit your options in the future.

The sale of any appreciated asset generally results in capital gains tax on the difference between the sale price and the seller's capital investment. When funds are invested in marketable securities, the taxpayer often has opportunities to manage the tax implications over time, by liquidating a holding gradually or using capital losses to offset gains. On the other hand, investing in real estate has its own advantages, but mitigating the tax consequences of a sale is more challenging. The transaction is likely to result in a significant capital gains tax in the year of sale, a problem which is compounded if the owner has significantly depreciated the property for income tax purposes, thereby reducing its cost basis.

A well known strategy to defer capital gains on the sale of real estate is what's known as a section 1031 exchange. In some circumstances, one property can be swapped for another property of a similar character without the need to recognize gain. In its purest form, the strategy is not complicated: imagine one investor owns a farm and one investor owns a factory. If the farmer longs for city life and the manufacturer misses the open skies, they can trade properties. Assuming the investments are of equal value, neither of them will face a capital gains tax at the time of the swap. One of the key advantages to the exchange is that each owner's purchasing power remains intact. If they each simply sold their properties and paid capital gains tax on the appreciation, they would have less capital to invest in a replacement property.

Of course, life rarely works out that neatly, so it's much more common for investors to use a deferred 1031 exchange, otherwise known as a Starker exchange. This can be a versatile and valuable strategy, but it can also be complicated and cumbersome. It's important to get a handle on the requirements and to enlist competent financial, legal, and tax advice before deciding if it's the right choice. Depending on your larger financial picture, a 1031 exchange may not be the right solution for you, and it's not the only way to mitigate the capital gains consequences of a sale of appreciated assets. Charitable planning strategies can also be a good solution to capital gains problems.

Nuts and Bolts of a 1031 Exchange

There are a few important points to keep in mind about 1031 exchanges in general. The first is that the property must be held for investment purposes of for use in a trade or business. Personal residences and vacation homes do not qualify. Some personal property (i.e., property other than real estate) held for investment purposes or for use in a trade or business may also qualify, although in general, securities do not.

Both investments must be "of like kind," that is, they must be of a similar character or nature. Most real estate is considered "like" to other real estate, whether it's improved or not, residential, commercial, or industrial, as long as it's investment property. Real estate is not of like kind to personal property, even if held as an investment. Personal property can be considered of like kind to other personal property, but meeting the requirement is harder.

The like kind requirement means that a 1031 exchange is useful to a real estate investor only if the goal is to stay in real estate. If you're considering engaging in a 1031 exchange for personal property, you should get an opinion from your tax or legal advisor about what assets will qualify.

The Challenges of Deferred 1031 Exchanges

Deferred 1031 Exchanges have strict requirements under the Internal Revenue Code. First of all, once the original property is sold, the taxpayer cannot take possession of, or exercise direct or indirect control over, the proceeds of the sale. Until they are disbursed to the seller of the replacement property, the funds must be held by a qualified intermediary.

The taxpayer has a strict timeframe in which to complete the transaction. From the date of sale the original property, he or she has forty-five (45) days in which to identify up to three options for the replacement property. The buyer must make that identification in writing to the proposed seller or to someone else involved in the transaction, such as the qualified intermediary. The closing on Property #2 must take place within 180 days of the closing on Property #1.

The titleholder on the new property must be identical to the titleholder on the old property. For example, if a wife is the seller in the first transaction, her husband cannot be the buyer in the second transaction. While partnerships, LLCs, and corporations can participate in 1031 exchanges, if an LLC is the seller in the first transaction, that LLC, not a member of the LLC or another LLC with the same members, must be the buyer in the second transaction.

While partial 1031 exchanges are possible, only the proceeds of the sale that are invested in like kind property will eligible for tax deferral.

This is not an exhaustive description of the nuances and requirements of deferred exchanges. Again, it's critical to seek advice from qualified tax and legal advisors to ensure that nothing is missed.

Variations on a Theme

For many individuals and families, investing in real property is the cornerstone of their wealth, their place in the community, and the legacy they leave behind. But it can also come with significant management and maintenance obligations that can become too much of a burden over time. Owners who want to simplify their lives may hesitate to explore a 1031 exchange because of the rule that real estate must be replaced with real estate. However, the definition of real estate may be broader than they realize.

Fractional interests in real estate can qualify for 1031 exchanges just as sole ownership can. Alternative strategies involving fractional ownership can sometimes offer greater flexibility and stability. They can also relieve an investor of the burden of actively managing a piece of real estate, making them attractive for property owners who no longer wish to be landlords.

These fractional interest strategies are all complex, and they all come with significant risks that need to be weighed carefully against the potential advantages. It would be impossible to cover all those risks here, so it's extremely important that you work with experienced advisors to vet the strategies and then, if you decide to proceed, to implement them properly. These are all better suited to sophisticated and experienced investors, and some are only available to people who qualify as "accredited investors."

Tenants-in-Common Projects

One way to co-own real estate is as tenants in common (TIC). The owners each hold a fractional share. You may own a piece of property as tenants in common with your spouse, sibling, or neighbor, but it's also possible to purchase a prepackaged, syndicated interest in a Tenants in Common Project from a securities broker. These projects often invest in large-scale investments such apartment buildings, commercial shopping centers, and hotels. Owners may hold equal or unequal interests. This is considered a real estate investment, and is eligible for 1031 treatment when exchanged with other real estate investments. The day-to-day management of the property is handled by management professionals.

There are some key things to be aware of. They are largely illiquid and are generally long-term investments. The quality and reliability of the investments vary and you should thoroughly vet the syndicate sponsoring the project. And it's important to understand that the owners take title to a share of the real estate, and therefore they share in the liability. Your legal advisors may suggest you address that risk by creating an LLC to hold the ownership interest.

Delaware Statutory Trusts

A Delaware Statutory Trust (DST) is similar to a TIC Project. It's a prepackaged, syndicated investment that qualifies as "like kind" to other real estate and typically involves high quality commercial properties.

The fundamental difference between a DST and a TIC is that instead of owning direct shares in the specific real estate, the client owns beneficial interest in a trust, which, in turn, owns the property, This gives the investor a layer of asset protection without the need to establish an LLC to hold the investment.

UPREIT Contributions

A Real Estate Investment Trust (REIT) is a security that holds underlying real estate. Interest in REITs can be private or exchange-t, but they do not qualify as real estate for 1031 exchange purposes. However, it is possible to invest in an Umbrella Partnership Real Estate Investment Trust (UPREIT) and take advantage of section 1031.

Typically, a commercial property owner contributes an interest in real estate to the Umbrella Partnership, of which a REIT is a partner. In exchange, the contributing property owner receives units in the Umbrella Partnership. Advantages include the ability to defer capital gains until the UPREIT sells the property. Further, the UPREIT gives the owner a stake in a more diversified real estate investment portfolio. The partners in the UPREIT usually have the right to convert their interests into ownership in the REIT. If that option is exercised, capital gains would be triggered at that point because the interest would become personal property rather than real property.

There are also disadvantages, such as limited liquidity, and the fact that the Partnership can trigger capital gains by selling underlying property. This is a complicated strategy with significant risk, so proceed with caution and with help from experienced advisors.

Charitable Planning as an Alternative to a 1031 Exchange

For the charitably minded, planning options exist that can defer capital gains tax or lessen their impact, without the use of a 1031 exchange. This could be as simple as making a gift of the appreciated property to the charity of your choice. In general, charities are exempt from income tax, so the organization can decide whether to retain or sell the property, depending on its needs. The donor will be able to take an income tax deduction based on the value of the gift. Of course, giving away a property outright may not be feasible, even to the most generous donors. By using a "split interest" charitable trust, it's possible to help the charity, receive a tax benefit, and also retain some benefit from the property for the donor or the donor's family.

Charitable Remainder Trusts

A Charitable Remainder Annuity Trust (CRT) is an irrevocable trust where the donor contributes property, often a highly appreciated asset, and retains an income stream from the trust for a set number of years or for life. The trust can be either a Charitable Remainder Annuity Trust (CRAT), where the payment is a set percentage of the initial contribution, or a Charitable Remainder Unitrust (CRUT), where the payment is a set percentage of the trust's principal, as it then stands.

A CRT qualifies as a charitable entity, therefore it can sell the donated property without recognizing capital gains. The sale proceeds are then available to reinvest. At the end of the trust's term, the remaining interest passes to the charity or charities chosen by the donor. Until then, the donor receives a stable income stream and can use it for whatever purpose he or she wishes. If it's not needed to cover living expenses, the donor may choose to use the funds to establish a gifting program that will create a legacy for children and grandchildren.

The payments from the trust to the donor will be at least partially taxable, so while the capital gains on the donated property can be stretched out over time, donors must understand that the CRAT does not avoid the tax completely.

Charitable Lead Trusts

In effect, a Charitable Lead Trust (CLT) is the reverse of the CRT. It can also be established as an annuity trust (a CLAT) or a unitrust (a CLUT). The charity of the donor's choice receives the income interest during the trust's term, and at the end of the term, the remainder reverts to the donor or is distributed to non-charitable beneficiaries, usually the donor's children and grandchildren.

In some cases, it's possible to pass the trust's remainder to family without making a taxable gift or taking a reduction in the donor's lifetime estate and gift tax exemption. This is called a zeroed out charitable lead trust. The value of the charity's income interest offsets the value of the ultimate gift to the family.

Depending on how the trust is drafted, the donor may also be able to take a charitable income tax deduction in the year of the donation. The downside to that is the donor is required to retain the income tax liability over the trust assets after it's funded. Still, there can be incredible utility to this strategy for charitably minded people who have estate tax concerns or who are seeking current income tax deductions. It's especially attractive in today's low interest rate environment.

A variation on a standard CLT is a Step-CLAT, where the payments to the charity are designed to increase over time. Lower payouts in the beginning years can mitigate some of the risk of early losses while allowing for greater future growth of the investment. Alternatively, a "Shark Fin" CLAT incorporates a large balloon payment to the charity in the final year of the trust. Because these CLATS are somewhat controversial and tend to be closely scrutinized by the IRS, the advice of an experienced attorney is particularly important before you proceed.

Your Exit Strategy and Beyond

These are just some of the strategies that can have a role to play in either deferring or mitigating capital gains exposure. The most important thing is that you have plan, whether it ultimately includes ones of these solutions or not. Ideally, an exit strategy should be in the works far in advance of the actual exit. Clients often make the same mistake when selling real estate as they do when selling a business: they leave fundamental planning issues until the last minutes, when it is not really planning at all. The exit strategy can have enormous implications on retirement income and legacy plans so modeling well in advance is an essential element in building solid long-term financial strategies.

It’s critical to consider your all important financial decisions as pieces of a whole. If you make a decision only in the context of income taxation, you may compromise legacy or philanthropic planning concerns. Taxes, retirement income, wealth transfer, and philanthropy are all inter-related. Your tax, legal, and financial advisors should be able to make recommendations that take into account your short, mid, and long-term financial goals broader financial goals and objectives.

About Brix Wealth Management

The Brix Wealth team, in conjunction with competent and specialized tax and legal counsel, provides strategic planning on wealth accumulation and legacy issues for individuals and their families who own highly appreciated and illiquid assets such as real estate or non-public business interests.

SOLUTION BY BRIX

A recent client was part of a consortium of investors who wanted to purchase highly appreciated real estate—a $50 million commercial property—in a fast-growing market. The challenge? The sellers were concerned about the significant capitals gains tax liabilities if they sold the property outright. The deal was in jeopardy. Our clients, as potential purchasers, needed out of the box strategies they could propose to the sellers to enable the transaction to go forward. The options contained in this document, when presented and discussed in depth, provided the solution.