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Minimize taxes when selling appreciated real estate - by Ronald Birnbaum

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In my 25 years as a financial advisor I have been asked by many clients how to sell investment real estate without paying a high tax bill. Today's top tax capital gains bracket is 23.8%, including the 3.8% tax from the Affordable Healthcare, which may be repealed this year. But taxes on investment real estate do not end there. You also are subject to depreciation recapture in addition to your capital gains tax. On real estate which has been held for many years, that means giving up about 25% of all depreciation taken in the form of an added tax. No wonder people ask about techniques to lower their tax bite. For some of my clients using a special trust can work to defer taxes for many years. The property owner sells the property to the trust, who sells it to a buyer. The trustee then invests the proceeds and distributes income to the original property owner. Taxes on the sale are deferred until the capital gains are distributed to the buyer. This little known technique is effective for those who do not want to re-invest in real estate. But as no step-up basis is available to heirs, the 1031 exchange is more popular with our clients.

Clients generally want to sell their investment property to get out of property management responsibilities. Through a 1031 exchange, clients can "exchange" their property for professionally managed real estate with high credit quality tenants. Although an exchange in the eyes of the IRS, this involves selling real estate and re-investing into other property within the IRS guidelines for a successful 1031 exchange. We educate and guide our clients through this intricate process so they pay no income taxes on their sale. Their basis, gain, and tax bill are technically deferred until the sale of their replacement property. But when the replacement property gets sold, another 1031 can be done. This process can be repeated until the property owners pass away, leaving heirs their real estate with little or NO tax bill, as the heirs got a step-up basis when they inherit the real estate. Thus, my clients are eligible for ownership in institutional, income producing real estate that they have no management responsibilities, and can enjoy tax-advantaged income from ownership for many years. When they pass, their heirs can take the profits without a large tax bill, usually paying little to no taxes when they sell.

Here are some options for 1031 exchanges. I will only cover replacement properties that feature little or no management responsibilities for investors:

Single tenant, triple-net lease retail: Some investors will find high quality single tenant properties attractive as their 1031 replacement property. These properties seem secure as they have high quality tenants like CVS, Walgreens, or Burger King. The problem with retail properties today is the lack of substantial rent escalations in their long-term leases. In a rising interest rate environment, which I and most economists are expecting us to enter in the not distant future, rent increases built into these leases may fall behind inflation, leading to a loss in the value of the property. But for some investors having very high quality tenants for a long-term hold is attractive. I tend to prefer properties with short leases, like apartments.

Local apartment building with hired property manager: I prefer real estate with shorter term leases like apartment complexes for 1031 replacement property. But due to economies of scale and high apartment values in the Boston area, it is difficult to buy a managed apartment building in desirable areas in Greater Boston and make positive cash flow. Those that want total control of their real estate may like this option.

Delaware Statutory Trusts (DST): These trusts confirm to IRS Revenue Ruling 2004-86. They are technically both a security and real estate. As a security, they can only be sold through brokers with security licenses, so most realtors do not offer these types of properties. The DST property is offered by professional real estate companies through security brokers. Popular DST real estate purchased through DSTs include retail, medical offices, and apartment complexes. They all offer tax-advantaged and appreciation potential. They also provide non-recourse debt with tax advantages. We have offered DSTs to our clients for over 12 years and have contacts throughout the United States to provide the DSTs that meet the needs of our clients.

Tenant In Common Structure (TICs): The first securitized real estate structure these are used today only for large cases, roughly $3,000,000 and greater. They can provide greater appreciation potential than DSTs due to a more flexible structure as granted by the IRS revenue ruling 2002-22. We have contacts with several companies that can provided customized real estate through a TIC structure.

Oil & Gas Royalty Trusts: These investments are also usually made through security brokers, thus there existence is not widely known. There are certain types of oil & gas investments which are considered “like-kind” as a real estate 1031 exchange. Thus, you can sell traditional real estate and ‘replace’ that real estate with royalties from oil & gas wells. O&G royalty offerings which are available for 1031 exchanges are usually 5-7 year programs.

Income is less predictable than with real estate offerings, but at current low oil & gas prices the royalty leases are being bought at low prices. That should translate to very promising income for investors, possibly earing 2-4 times the income generated from real estate offerings. At the end of the program, the plan is for the royalty leases to be sold to institutional investors at a profit. The total return on these programs can be significant with excellent income potential. Of course, there are risks in all securities and any one program may return less or more than the planned amount. Still, using oil & gas royalties can be an attractive piece of a diversified 1031 portfolio.

As a leader of providing this management-less, 1031 replacement property for our clients who wish to sell their management intensive real estate, we welcome interested parties to contact us for a consultation.

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