"40% in Taxes… Are You Kidding Me??"

I recently received a call from a long-time client who is selling a valuable piece of coastal real estate. He is extremely frustrated by the enormity of taxes he will have to pay for the privilege of living in California!

And in case you haven't sold a business, a piece of real estate or other appreciated asset lately – it is quite a "joy-robber." Just how bad is it? Would you believe nearly "40% bad?"

How can it be almost 40% in taxes on any appreciation or gains in the asset?

- The Federal long-term capital gains tax is 20%.
- The Franchise Tax Board takes 13.3% for the highest tax bracket.
- And in most cases there is an additional 3.8% Medicare tax.

Are there tools, techniques or strategies that could lessen the tax bite? Yes, there are! My client was relieved to discover that *there are at least four other strategies in addition to the 1031 exchange approach* to consider for deferring or even *eliminating* taxes on the sale of appreciated real estate.

<u>1031 Exchange</u>

But before we get ahead of ourselves, what is an Internal Revenue Code Section 1031 exchange, and why not use it? A 1031 exchange requires the seller to locate "like kind" property within 45 days and complete the sale within 180 days. At the best of times, this is a complex transaction with a very limited time constraint. It is especially difficult in the current San Diego market because there is so little quality inventory to "exchange" into.

According to respected local real estate professional, Limor Spilky, who is a Senior Associate at Locations Matters Inc. in Del Mar, "In speaking with property owners in coastal and urban San Diego, the consensus is that they have never seen a more difficult time to find replacement property for a 1031 exchange."

<u>Installment Sale</u>

So, if you are not using a 1031 exchange, what other options should you consider? Please note that I am neither an attorney nor a certified public accountant and recommend that you seek outside professional counsel before engaging in the potential option discussed below.

One strategy that can be used in addition to the 1031 exchange is an Installment Sale, which is covered in Section 453 of the Internal Revenue Code.

In the typical Installment Sale, the buyer agrees to make regular payments of principal and interest, usually monthly, directly to the seller (rather than borrowing money from a bank). The seller of the property retains legal title to the property until the property is fully paid for.

The amount of the down payment, length of the payments, interest rate, and amount of the monthly payments are all negotiable and are set forth in an Installment Sale Note.

*Advantages*:

- Capital gain taxes may be deferred over the period of the Installment Sale Note, which depends upon how the note is structured and how much of the transaction is financed.
- It provides for an ongoing income stream over a specified period of time.

*Disadvantages:*

- It does not eliminate the tax … it merely spreads it out over time.
- Depreciation recapture (if any) is taxed in the year of the sale.

Stay tuned for next month's article, where I will discuss two additional strategies that can be used to defer or even eliminate taxes on the sale of appreciated real estate.

R. J. Kelly is the Founder and Chief Visionary Officer of the Wealth Legacy Group, Inc. in San Diego, CA. Learn more about R. J. and Wealth Legacy Group at www.wealthlegacygroup.com, or call (800) 975-5355.

Wealth Legacy Group