



## **Question of the Month: What are the typical methods available to taxpayers for deferring capital gains on real estate sales?**

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Those who own real estate, especially those with highly appreciated values, are often hesitant to sell them because of the tax ramifications of capital gains associated with the sale. In addition to capital gains tax, asset sales can also lead to depreciation recapture which is essentially a higher tax rate associated with the depreciated component of the asset's historical cost. However, there are many tax deferral methods available to taxpayers. The methods discussed in this article are the Like-kind Exchange otherwise known as a Section 1031 Exchange, an Installment Sale through a Seller Carryback Note, and a Structured Sale through a Deferred Sales Trust, or DST. There are other methods available, however only the most frequently used will be discussed.

The Like-kind Exchange is the most popular method used when deferring capital gains tax. It not only results in the deferral of the capital gains tax but also defers the depreciation recapture tax. A Like-kind exchange is when the proceeds of the property sold are used to purchase a similar property for a similar purpose. The effect is that the capital gain is "rolled" into the value of the new asset, thereby deferring the capital gain until the new property is sold. The advantage is that the seller has deferred the capital gain indefinitely or until the second property is sold outright (no new exchange). If the new property with the prior property's capital gain rolled into it is held for the duration of the real estate owner's life, the deferred capital gain becomes a step-up in cost basis to their heirs upon death effectively eliminating the capital gain and depreciation recapture taxes altogether. The disadvantage is that some real estate investors may be at a point in their life where they wish to cash out and not invest in more real estate.

Declaring capital gains under an installment sale is the simplest of all methods covered in this article. An installment sale essentially functions like an annuity, where a prorated portion of each payment is considered a return of principal. In the year the sale takes place, the transaction is reported in whole, irrelevant of when payments are received. A gross profit percentage is determined and all subsequent years payments received are divided amongst return of capital and capital gains in accordance with the gross profit percentage determined in the first year. Due to its simplicity and frequency of use, this method incurs the least cost of analysis by the tax preparer and involves no outside consultation or analysis by a specialized accountant or consultant. The disadvantage is that there is always the possibility that the buyer will default on the promissory note. The process to foreclose, repossess, or otherwise resolve the default can consume significant amounts of time and money and the property may have been damaged during the buyer's ownership. Although the real estate seller is deferring the capital gains tax they are not deferring the taxes due to depreciation recapture.

A Structured Sale through a DST is the most complex of all capital gain deferral methods discussed.

A Structured Sale through a DST is essentially an installment sale between yourself and an independent trust. The trust must employ a trustee that is truly independent from the owner/beneficiary. If the IRS should determine that this is a "sham trust," the income from the initial sale is taxed as though the trust did not exist. The advantages are all of the advantages of an ordinary installment sale but without the disadvantages of the ordinary installment sale. Instead it has its own disadvantages and they are significant. First, the seller would have to give up control of their property to the independent trustee. Another is that there is little to no guidance on this by the Internal Revenue Service. This is not covered in the Internal Revenue Code that governs installment sales nor is there any case history.

Capital gain strategies for tax-deferral or tax-exclusion can be complicated and confusing to many, so it is critical that real estate owners review capital gains and depreciation recapture taxes with their income tax advisors, especially the tax deferred and tax exclusion options available to them.

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