How to exit the real estate merry-go-round in a tax efficient way - by Jordan Toder

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The prospect of paying tax on long held real estate assets lead many owners to seek a Section 1031 tax free exchange. That solution, and it's restrictions, have given birth to tax smart alternatives, such as TIC's and DST's. Those strategies defer the taxable gain while offloading hands-on management, not offset the tax due.

Hedge fund managers, in 2017, were facing a tax that came due, the repatriation of foreign gains. Some managers moved to lower tax environments; however, that solution is not readily available to real assets. Though diametrically opposed in investing styles there are structures that worked for hedge fund managers in 2017 that can work for real estate owners with taxable gains in 2020.

That solution is the charitable lead annuity trust (CLAT). The CLAT contribution is tax deductible for the charitable component. The CLAT splits benefits between a charity and a personal beneficiary. The CLAT income is directed towards a charity or Donor Advised Fund (DAF), any remainder is paid to the personal beneficiary only after the charitable obligation is fulfilled.

What made this so powerful back in 2017 is even more powerful today. The government measures the charitable component using the Sec. 7520 rate, announced monthly and currently 0.4%.

There are two natural arbitrages, interest rate and mortality, that are currently available to CLAT grantors.

Simply speaking, if I create a $1 million CLAT and return that amount plus a 0.4% return, I receive a full tax deduction for my contribution (there are additional tests not considered in this discussion). My family keeps anything above that return. Current available investments that exceed the 0.4% hurdle is a gain for the CLAT beneficiary.

By structuring a CLAT with a mortality component and using commercially available life insurance further enhance the tax efficiency.

In general, life insurance allows for tax free death benefits, Sec 101. By using a mortality based CLAT and life insurance we marry a perfectly suited product with the maturity event of a CLAT. Generally, death benefit products guarantee 4% or greater for maturity well into the persons 90s.

A natural arbitrage occurs with the government mortality table used to measure the charitable benefit and the actual mortality experienced by the CLAT donating public, generally higher in the socioeconomic index. In other words, the government table indicates an earlier death leaving more of the contribution to the family.

The best part of a mortality CLAT is the family benefit is transferred free of any gift tax, with no impact on the Unified Credit Exemption, sunsetting to a joint $11 million (plus CPI increases) in 2026.

The result is a fully deductible CLAT contribution with a significant amount of the contribution inuring to the family benefit. Our experience is the average size CLAT is $3 million+ working best for ages 65 and younger.

What are the negatives? You use assets from your balance sheet to provide the contribution. You are limited to 30% of your AGI, though you can carry forward any unused deduction up to an additional five years. Lawyers and accountants may not know about this because it includes a niche strategy using insurance, not their specialty, and some people have already given enough to their heirs.

The CLAT provides a trifecta benefit of a deductible contribution, a guaranteed charitable legacy and preserving wealth for future generations.

Jordan Toder, CEP, CLU, is principal at Preservation Capital Partners LLC, Garden City, N.Y.

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