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Minimize (or Eliminate) Taxes When Selling Your Rental Property

An Exclusive Special Report From www.cdaaccounting.com

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Maximize Profits and Defer Taxes with an Installment Sale

Do you own investment property? What about a small business? Sooner or later, you will probably want to sell.

One of the downsides of selling a business or investment property is the huge tax bill at the end. Profits are likely subject to the capital gains tax—perhaps at a much higher rate than you expect.

A seller-financed installment sale enables you to defer taxes to one or more later years, which is almost always a good idea.

And the installment sale could cut your tax bill if spreading out your profits over multiple years puts you in a lower tax bracket.

But as with most programs that can lower your taxes, your lawmakers and the IRS impose a number of limitations, as we will explain.

What Is an Installment Sale?

An installment sale is a sale of eligible property where you receive at least one payment after the close of the taxable year in which the sale occurs.[1] If you make a profit on an installment sale, you report part of your profit when you receive each payment.

You document the buyer's obligation to make future payments to you, with a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you. You should also secure the debt.

Although you can't use the installment method to report a loss, you can choose to report all of your gain in the year of sale.

Installment Sale Advantages

An installment sale offers a number of advantages for you as a seller, as well as for your buyer:

1. You can negotiate the sale without the need for the buyer to pay the full sale price when you finalize the sale.
2. You and the buyer can finalize the sale agreement without waiting for the buyer to qualify for third-party financing.
3. You and the buyer can tailor the terms of the sale to meet your needs without having to get approval from a third-party lender.
4. You can defer taxes on your gain, and potentially pay a lower tax rate in a later year.

5. The buyer receives full basis in the property.

How Is an Installment Sale Reported?

Payments that you receive from an installment sale consist of three parts:

1. Interest
2. Taxable part (gain or profit)
3. Non-taxable part (return of basis)

Each year you receive a payment, you pay taxes on the interest and taxable part. The part of the payment allocated to your basis is not taxable. Basis is the amount of your investment in the property for installment sale purposes.

After you've determined how much of each payment to treat as interest, you next determine the taxable portion of the remaining payment.

Example. You sell property at a contract price of $600,000, and your gross profit is $150,000. Your gross profit percentage is 25 percent ($150,000 ÷ $600,000). After subtracting interest, you report 25 percent of each payment, including the down payment, as installment sale income from the sale for the tax year in which you receive the payment. The remainder (balance) of each payment is the tax-free return of your adjusted basis.

Say your buyer makes a payment of $12,250, of which $2,250 is interest. Of the remaining $10,000, $2,500 (25 percent) is taxable profit and $7,500 is non-taxable return of basis.

No Installment Sale in These Instances

There are certain types of property and transactions for which the installment method cannot be used, such as:

- The sale of inventory consisting of personal property.[2] But this rule does not apply to property used or produced in farming.[3]
- The sale of real property held for sale to customers in the ordinary course of a trade or business.[4] But dealers of timeshares and residential lots can treat certain sales as installment sales and report under the installment method if they elect to pay a special interest charge.[5]
- The sale of stock or securities traded on an established securities market.[6]
- The sale of depreciable property to a related buyer, unless you can show to the satisfaction of the IRS that the sale was not made for tax avoidance.[7]

Minimum Interest Requirements

Interest earned from an installment sale must be reported as ordinary income. Interest is generally not included in the down payment. But you will have to treat part of each later payment as interest, even if it's not called "interest" in your agreement with the buyer.

Because the possibility exists for sellers to manipulate their tax bill by charging an unreasonably low rate of interest and inflating the sales price in an installment sale, the tax law requires you to charge a minimum rate of interest equal to the lower of 9 percent or the applicable federal rate (AFR), which the IRS publishes monthly.[8] For February 2023, the minimum annual interest for a 15-year installment note is 3.86 percent.[9] Thus, for an installment sale in February 2023, your installment note must call for 3.86 percent interest or more.

If the correct amount of interest is not stated in your agreement, the IRS will impute interest at the lower of 9 percent or the applicable AFR.

Sales to Relatives and Other Related Parties

If you sell depreciable property on an installment contract to your brother, sister, spouse, parent, grandparent, child, or grandchild[10] and that relative sells the property within two years of acquiring it from you, you are treated as receiving a payment equal to what your relative received.[11]

In other words, under this two-year requirement, the law treats the sale by your relative as if you were the seller.

Bad news for you.

You are treated as if you have the cash, which you don't. Your relative has the cash. And now you are going to pay taxes as if you have the cash.

The two-year resale rule also applies to sales by you to the following entities:[12]

- Corporations in which you and your relatives directly or indirectly have 50 percent or more ownership
- Partnerships in which you have an interest
- Trusts naming you as a beneficiary
- Grantor trusts that treat you as the owner

Avoid Intermediary Installment Sales

To avoid the uncertainty concerning whether you might actually get paid the contract sales price in an installment sale, you may be tempted to engage in an intermediary installment sale.

Intermediary installment sales are marketed transactions that involve an intermediary who is formally independent from the seller but who, practically speaking, is a paid agent of the seller.

The intermediary purports to buy the asset from the seller for an installment note, receiving a cost basis. The intermediary then immediately sells the asset, tax-free, to a prearranged buyer for the same price in cash, which is used to service the installment note.

This arrangement avoids the uncertainty, involved in any installment arrangement, that the buyer might default on the note and you might not be paid in full.

But the IRS position is that such an arrangement lacks economic substance and is therefore not really an installment sale between two independent parties.[13] Thus, the IRS will treat an intermediary installment sale in the same manner as it treats an installment sale to a family member or other related party.

Takeaways

Here are some key insights from this article.

- The installment sale enables you to defer tax on your gain, and likely also to have your gain taxed at a lower tax rate.
- You have considerable flexibility in establishing the terms of sale, but the IRS does require at least a minimum interest rate.
- Sales to related parties generally are disallowed unless the related party keeps the property for at least two years before selling.
- Intermediary installment sales lack economic substance and are disallowed under the two-year related-party rules.

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[1] IRC Section 453(b)(1).

[2] IRC Section 453(b)(2)(B).

[3] IRC Section 453(l)(2)(A); IRS Pub. 537, Installment Sales (2021), dated Dec. 15, 2021, p. 3.

[4] IRC Section 453(l)(1)(B).

[5] IRC Section 453(l)(2)(B).

[6] IRC Section 453(k)(2).

[7] IRC Section 453(g).

[8] IRC Sections 1274A; 1274; 483.

[9] Rev. Rul. 2022-12.

[10] IRC Section 267(b); IRS Pub. 537, Installment Sales (2021), dated Dec. 15, 2021, p. 6.

[11] IRC Section 453(e)(1).

[12] IRS Pub. 537, Installment Sales (2021), dated Dec. 15, 2021, p. 6.

[13] IRC Section 453(e)(1).

Passive Losses Don't Destroy Your Tax-Favored Capital Gains

Do you have rental properties or other businesses that create suspended passive losses?

Note. Your suspended passive losses are those losses that you were not able to deduct in prior years because of the passive loss rules.

When you dispose of your entire interest in a passive activity (or group of activities if grouped) in a fully taxable transaction, you release the suspended passive losses from that activity.[1]

Say you have this situation:

1. $300,000 of long-term capital gain from the sale of your Pine Street rental property (this property is not grouped)
2. $100,000 of suspended passive losses from the Pine Street property
3. $200,000 of suspended passive losses from other rental properties

How do you benefit from the sale of your Pine Street property?

Tax Attributes Don't Change

The number one thing to know is that although any gain or loss from the disposition of a passive activity is passive, such gains or losses retain their tax characteristics.

The passive loss rules sometimes create taxpayer confusion over what happens when you make a total disposition of a passive activity. For example, the long-term capital gain from the total disposition of the Pine Street property creates passive income under the passive loss rules,[2] but the gain retains its character as long-term capital gain, and it's taxed at tax-favored long-term capital gains rates.

Passive activity losses come about when the losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year.[3] You carry passive activity losses forward until you can use them against passive income.

The passive loss rules found in IRC Section 469 are merely loss disallowance provisions, and as such they do not change the character of any gain or loss.[4]

Example

Let's go back to your hypothetical Pine Street situation and see what happens under these rules:

1. On your $300,000 capital gain from the sale of your Pine Street rental property, you have both long-term capital gain and "unrecaptured Section 1250 gain"—and both types of gain receive tax-favored capital gains rates.
2. Your sale of the Pine Street property is a complete disposition of that property, and that complete disposition releases the $100,000 of suspended passive losses that are now fully allowed against all of your other income. This $100,000 of losses includes losses from this year.
3. You still have $200,000 of tax code–defined passive gain remaining from the sale of the Pine Street property, and that releases $200,000 of your suspended passive losses from your other rental properties. You take the suspended losses as ordinary losses against all your other income.

Takeaways

The passive loss rules do not change the character of any gains or losses.

- When you sell a property, the character of your capital and ordinary gains doesn't change, albeit those gains count as passive income that enable passive loss deductions.
- If all or some portion of a capital gain is attributable to real property depreciation, you are taxed at the rates that apply to unrecaptured Section 1250 gain.
- The release of your rental passive losses creates ordinary deductions that you apply against all other income.

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[1] IRC Section 469(g)(1).

[2] Reg. Section 1.469-2T(c)(2).

[3] IRC Section 469(d)(1).

[4] IRC Section 469; CCA 201312041.

Section 1031 Exchanges vs. Qualified Opportunity Zone Funds: Which Is Better?

Let’s say that Larry Landlord purchased a residential rental duplex 20 years ago for $100,000 and it’s now worth $1.1 million.

Larry wants out of this property, but he doesn’t want to pay $238,000 in tax on his $1 million capital gain.

One option is to defer the tax due on the gain by doing a Section 1031 exchange for another real property—for example, Larry could sell his duplex and use the proceeds to purchase a rental triplex of equal or greater value.

But there is another option: selling the property and investing the proceeds in a qualified opportunity zone fund. Which is better? Like most things in life, it depends. Specifically, it depends on Larry’s goals.

Goal: Get Out of the Real Estate Business

If Larry is tired of being a landlord and wants to get out of the real estate business, a Section 1031 exchange won’t help. You must exchange one property for one or more like-kind properties of equal or greater value. “Like-kind” real property is very broadly construed to include all business and investment real property in the United States, whether improved or unimproved.[1]

Larry doesn’t have to exchange his rental duplex for another residential property. He could exchange it for an office building, a farm, a ranch, or a strip mall. But with the exchange, he’ll still be a real property owner with all the headaches and responsibilities that entails.

Investing in an opportunity zone is different. You don’t buy and manage a specific property. Instead, you sell your real property (or any other capital asset) and invest all or part of the proceeds in a qualified opportunity fund (QOF). QOFs are corporations, partnerships, or LLCs organized to pool money from investors to invest in opportunity zone property.

There are thousands of QOFs to choose from. The vast majority of QOFs invest in real estate, although they can invest in other businesses in opportunity zones. The QOF (not the investors) manages the real estate.

So if Larry wants to relieve himself of actively managing a real property investment, putting his money in a QOF is the way to go.

Goal: Diversify Your Real Estate Investments

Ordinarily, when you do a Section 1031 exchange, you replace one property with another.

In contrast, you can diversify your holdings when you invest in a QOF. First, you can invest in more than one QOF. Also, many QOFs have multiple real properties in multiple opportunity zones.

Goal: Defer Long-Term Capital Gains

Gain in a like-kind exchange is tax-deferred until you sell or otherwise dispose of the property you receive in the exchange. You can do as many like-kind exchanges as you want. So long as you exchange for replacement property of equal or greater value, you'll owe no tax.[2] Thus, Larry can defer paying tax on his $1 million capital gain for decades.

In contrast, capital gains invested in a QOF are tax-deferred only until December 31, 2026. At that time, the capital gains tax must be paid.[3] Thus, Larry would pay capital gains tax on his $1 million gain from the sale of his duplex with his 2026 tax return.

Goal: Sell the Property in 10 or More Years

A Section 1031 exchange is tax-deferred, but it is not necessarily tax-free.

The basis of the original property follows the property owner through the exchange and is used when the replacement property is ultimately sold.[4] Upon such a sale, the owner must pay capital gains tax on the difference between the basis in the original property and the sale amount of the replacement property.

For example, let's say Larry sells his replacement property triplex for $2 million in 10 years. Since the basis in his original duplex was $100,000, he'll owe capital gains tax on $1.9 million ($2 million - $100,000).

In contrast, when an investor sells his or her investment in a QOF, its basis is increased to its fair market value at the time of the sale, provided that the QOF was held for at least 10 years.[5] Thus, if Larry sells his QOF investment for a $250,000 profit in 2033, he'll owe no tax. This is a huge tax benefit for those who are willing to hold on to their investment for 10 years.

You may hold your QOF until 2047 and avoid paying capital gains tax on any appreciation that occurs through the end of that year.[6] But it's anticipated that most QOF investors will sell after 10 years. For this reason, QOFs are best viewed as a medium-term (10-year) investment.

Goal: Give the Property to Your Heirs Tax-Free

Section 1031 exchanges are a superb estate planning tool because the taxes deferred in the exchange can roll on indefinitely until the property owner dies. At that time, the owner's heirs will get a step-up basis equal to the property's fair market value at the time of death. The heirs can then immediately sell the property tax-free. In other words, the capital gains disappear.

For example, if Larry exchanges his $1.1 million duplex for a triplex that is worth $2 million, when he eventually dies, it will get a step-up basis to $2 million. His heirs can sell the property for $2 million tax-free.

With a QOF investment, there is no step-up upon death. If Larry dies before December 31, 2026, his heirs will assume the original tax basis in the QOF and will have to pay tax on Larry's $1 million capital gain with their 2026 return.

But if Larry's heirs hold on to the QOF for 10 years, it will receive a step-up to its fair market value when they sell it. They won't need to pay capital gains tax on the appreciation of the QOF.

Goal: Gain Liquidity by Freeing Up Original Principal

You have to invest only your capital gains from the sale of real property or other capital assets in a QOF.[7] You may keep your original basis in the property tax-free. For example, Larry's basis in his $1.1 million property is $100,000. He may pocket the $100,000 tax-free and invest the $1 million in a QOF.

In contrast, in a Section 1031 exchange, investors are required to leave in their original principal and their gains, and even roll forward their debt.

Goal: Maximize the Long-Term Value of the Real Estate

With a Section 1031 exchange, you may exchange for virtually any real estate of equal or greater value anywhere in the United States. You get to choose property with good investment potential. Once the exchange is completed, you own the property and can take steps to help increase its long-term value.

With a QOF, you are limited to giving your money to a fund that you don't own or manage. The QOF chooses the investment. Moreover, QOFs are limited to investing in opportunity zones. These are 8,764 census tracts total, in all 50 states. Most have at least a 20 percent poverty rate. But up to 5 percent of qualified opportunity zones did not need to be low-income, and much of the investment by QOFs has been in these less distressed opportunity zones.

QOFs are unregistered private placement investments outside of the Securities and Exchange Commission (SEC) oversight. They typically invest in either new construction in opportunity zones or significant rehabilitation projects. There is no guarantee they will choose investments wisely or manage them well. If the investment turns sour, there may be little or no appreciation after 10 years.

Goal: Achieve Simplicity

Section 1031 exchanges can be complicated. There are a lot of rules to follow. For example, you must identify a replacement property within 45 days after the property to be exchanged is sold.

The like-kind exchange must be completed within 180 days.[8]

Many Section 1031 exchanges are complex three-party exchanges in which a "qualified intermediary" sells the exchanged property and acquires the replacement property on the taxpayer's behalf. In a complex three-party exchange, the qualified intermediaries often charge hefty fees, and there are expenses as well.

Investing in a QOF is relatively simple. Once you sell property for a capital gain, you have 180 days to invest in one or more QOFs of your choosing.[9]

Takeaways

A Section 1031 exchange is preferable to a QOF investment if your goal is to hold on to the replacement property for the rest of your life and then give it to your heirs. Your heirs will get a step-up basis to current market value and be able to immediately sell it tax-free.

In contrast, capital gains tax must be paid in 2026 on the money invested in QOFs in 2023.

If you don't plan to hold on to your investment for life, investing in a QOF may be preferable to a Section 1031 exchange because there will be no tax due on any appreciation in a QOF after a 10-year holding period.

In contrast, if you sell Section 1031 replacement property, you must pay capital gains tax on the difference between the basis in the original property and the sale amount of the replacement property.

If you're looking to avoid the headaches and responsibilities that come with ownership of commercial or rental property, a QOF investment is preferable because the QOF—instead of you—manages the investment.

If you want to gain liquidity by freeing up your original principal in the property, you should invest in a QOF. With a QOF, you can invest some or all of your gain. But when you do a Section 1031 exchange, you must exchange both your principal and your gain for a replacement property.

If you are leery of investing in opportunity zones, which are low-income or low-income-adjacent areas, you should do a Section 1031 exchange. With an exchange, you can invest in almost any real property of equal or greater value anywhere in the United States.

[1] Reg. Section 1.1031(a)-1(b).

[2] IRC Section 1031(a)(1).

[3] IRC Section 1400Z-2(b)(1).

[4] IRC Section 1031(d).

[5] IRC Section 1400Z-2(c).

[6] Reg. Section 1.1400Z2(c)-1(c).

[7] IRC Section 1400Z-2(e)(1).

[8] IRC Section 1031(a)(3).

[9] IRC Section 1400Z-2(a)(1)(a).

Section 1031: Don’t Miss This Depreciation Election

As we just discussed in the previous article, the Section 1031 exchange allows you to sell a piece of appreciated real estate and defer all the taxes as long as you invest the entire proceeds in like-kind property.

And then consider this: a cost segregation study allows you to separate qualifying real estate into separate components with shorter depreciable lives that speed up deductions and in many cases create immediate write-offs.

Can you (a) defer a large gain via Section 1031 and (b) immediately create a large write-off on the new asset with a cost segregation study?

You can, but you have to make sure you don’t miss this one important step.

1031 Exchange Overview

The Section 1031 exchange allows you to sell appreciated real estate and defer all taxable gains when you fully reinvest the sales proceeds into new qualifying real estate.[1]

Example 1. You purchased a rental property five years ago for $200,000. The property has appreciated tremendously in the past five years and is now worth $500,000.

You depreciated the rental by $30,000, so its adjusted basis is now $170,000. If you sell for $500,000, you’ll have a taxable gain of $330,000.

But you don’t sell outright. Instead, you utilize a 1031 exchange to make the sale and roll the sales proceeds (and the taxable gain) into the purchase of an eight-unit apartment building that costs $1,000,000.

Key point. Many savvy investors continue using 1031 exchanges until death, when their relatives inherit the asset with a stepped-up basis.[2] And then, because of that stepped-up basis, those relatives can likely sell that asset federal-income-tax-free.

Cost Segregation Overview

Residential real estate is depreciated over a life of 27.5 years, and commercial real estate is depreciated over a life of 39 years.[3]

Example 2. You purchase a small apartment building for $1,000,000. A qualified appraisal shows that 80 percent is building and 20 percent is land.

This makes your depreciable basis $800,000. (You cannot depreciate land.)

You write off the $800,000 basis over 27.5 years, giving you annual write-offs of $29,091.

An applied cost segregation study breaks that $800,000 building into components such as appliances, flooring, lighting systems, and land improvements. The components have lives of 20 years or less, qualifying them for faster depreciation and bonus depreciation as well.[4]

For 2022, bonus depreciation is 100 percent, but it drops to 80 percent for 2023.[5]

Key point. Cost segregation studies use the depreciation rules in effect when you place the property in service, not when you do the study.[6] But you realize the tax benefits in the year of the study.

Example 3. Let's say that of the $800,000 apartment building basis, 25 percent ($200,000) goes to shorter-life assets and $600,000 to the 27.5-year depreciable life category. Because you placed this building in service in 2022, you can use bonus depreciation to immediately deduct $200,000 for the short-lived assets.

This would result in a first-year write-off of $221,818 ($200,000 + $21,818 = wow!) and a $21,818 write-off for Year 2 through Year 27.5.

Calculating Basis in a 1031 Exchange

When you complete a 1031 exchange, the basis in your new asset is calculated by reducing its value by the deferred gain. That new basis amount can be accounted for in two different ways, described below.

Method 1: Track two assets. With this method, the remaining basis of the old asset continues on its original timeline and the new "additional" basis of the new asset starts on a new schedule.[7]

Example 4. Your old asset had an adjusted basis of $170,000 and 22.5 years of depreciable life remaining when you sold it (via the Section 1031 exchange).

Under the track-two-assets method, you would continue tracking that same $170,000 and depreciating it across that same 22.5 years of remaining life.

Your new asset with a purchase price of $1,000,000 would be reduced by the amount of deferred gain of $330,000, and by the separate, old asset basis of $170,000, to get to your new/excess basis amount of $500,000.

Let's say that 80 percent of the $500,000 new/excess basis is building and 20 percent is land. You would depreciate the $400,000 building (80 percent x $500,000) over 27.5 years.

Method 2: Track one asset. Here, you make the IRS regulation 1.168(i)-6(i)(2) election.[8] This election allows you to treat the sum of the exchanged basis and the new/excess basis as one asset, both put into service at the same time.

Example 5. Your old asset's remaining basis of $170,000 would be combined with your new/excess basis of $500,000 ($400,000 for building and $100,000 for land). You depreciate the $570,000 building basis ($170,000 + $400,000) over 27.5 years.

In the example above, you lose out because you are depreciating everything over 27.5 years.

Cost Segregation Can Change the Game

If you will use cost segregation on the newly acquired Section 1031 asset, you may want to make the 1.168(i)-6(c)(5)(iv) election because that applies cost segregation to the entire basis.[9]

Example 6. Under the track-one-asset method, your depreciable basis is $570,000. If the cost segregation study shows that 25 percent of the basis is bonus depreciation or Section 179 qualifying property, you write off

- $142,500 immediately,
- $15,545 immediately, and
- $15,545 in subsequent years.

Example 7. Under the track-two-assets method, you apply the cost study to the additional investment's portion of the depreciable basis ($400,000, in this example). If the cost segregation study shows that 25 percent of the basis is bonus depreciation or Section 179 qualifying property, you write off

- $100,000 immediately in bonus depreciation or Section 179 expensing;
- $10,909 immediately in 27.5-year depreciation;
- $7,555 immediately in depreciation of the old $170,000 basis;
- $10,909 each year for 26.5 years; and
- $7,555 each year for 20.5 years.

Here, you can see that with cost segregation, the track-one-asset method is the winner—assuming you will keep the property in your real estate portfolio until death.

But we have to point out: there is more to consider that could change the result. For example, how long will you keep the property? With a short holding period, recapture on bonus depreciation and Section 179 expensing comes into play and could impact your selection of method.

Takeaways

Combining a Section 1031 exchange with a cost segregation study can produce great results.

Continuous use of the Section 1031 exchange enables you to continue upgrading your real estate portfolio without incurring any federal taxes on the upgrades. And you can keep doing this until you die.

When you upgrade your real estate using the Section 1031 exchange, you have the opportunity to use a cost segregation study to create large deductions in the year of exchange.

If you are going to use cost segregation on an asset acquired via a 1031 exchange, you need to consider the IRS Reg. Section 1.168(i)-6(c)(5)(iv) election to treat the sum of your old basis and your new basis as one asset.

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[1] IRC Section 1031(a)(1).

[2] IRC Section 1014(a).

[3] IRC Sections 168(b)(3); 168(c).

[4] IRC Section 168(k).

[5] IRC Section 168(k)(6).

[6] See Chief Counsel Notice 2004-024.

[7] Reg. Sections 1.168(i)-6(b)(7); 1.168(i)-6(b)(8).

[8] Reg. Section 1.168(i)-(6)(i)(2).

[9] IRS Reg. Sections 1.168(i)-6(i)(1); 1.168(i)-6(c)(5)(iv).

How to Section 1031 Exchange into a Delaware Statutory Trust

As you likely know, the Section 1031 tax-deferred, like-kind exchange is one of the greatest wealth-building mechanisms for real estate investors.[1]

With Section 1031, you can avoid taxes on all your property upgrades during your lifetime and then pass the property to your heirs when you die. The heirs receive the property with a step-up to fair market value, and they can likely sell the property and pay no taxes.

But what if you want to get off the landlord bandwagon? There are options. For example:

- You could use an UPREIT, as we will explain next in Cashing Out Real Estate Profits without Section 1031.
- You could invest in an opportunity zone fund, as we explained in Section 1031 Exchanges vs. Qualified Opportunity Zone Funds: Which Is Better?
- You could invest in a Delaware statutory trust as we explain in this article.

1031 Exchange Overview

The 1031 exchange, or like-kind exchange, has been around since the Revenue Act of 1921. Its purpose is simple: allowing you to swap a business asset without there being a taxable event, because your economic position hasn't really changed.

The basics of a 1031 exchange are pretty straightforward:[2]

- Before you sell the old asset, you must begin the exchange by contracting with a qualified intermediary.
- You may list up to three potential replacement assets within 45 days of the sale of your qualified asset.
- You must close on at least one of those three identified assets within 180 days of the sale.
- For the exchange to be fully tax-free, you must acquire a new asset of greater value than the one you're selling. If you don't trade up, you'll likely have some taxable gain.[3]

IRC Section 1031(a) provides that no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment (relinquished real property) if the relinquished real property is exchanged solely for real property of a like kind that is to be held either for productive use in a trade or business or for investment (replacement real property).[4]

Such Section 1031 assets include, among others:

- Residential or commercial real estate held for investment, rental, or business use

- Raw land held for investment
- Tenant-in-common held real estate
- Delaware statutory trust interests

Assets that don't qualify for Section 1031 include:

- Securities, stocks, and bonds
- Partnership interests
- Assets held as inventory[5]
- Personal-use real estate
- Foreign real estate

What Is a Delaware Statutory Trust?

The Delaware statutory trust property ownership structure allows you (as a smaller investor) to own a fractional interest in large, institutional-quality, and professionally managed commercial property along with other investors. Note that with the Delaware statutory trust, you are an owner.

And it's that ownership interest that makes an investment in a Delaware statutory trust a qualifying replacement asset for purposes of a 1031 exchange. Revenue Ruling 2004-86 confirms the Delaware statutory trust ownership and its qualification for a 1031 exchange.[6]

Some Thoughts on Delaware Statutory Trust Investments

Liquidity. Delaware statutory trusts do not have a secondary market. This means your money is locked up in this investment, perhaps for up to 10 years.

Minimum investment. In general, most Delaware statutory trusts require that you be an accredited investor. Such trusts do their own due diligence on your status, but in general you meet the requirements for classification as an accredited investor when[7]

- your income is $200,000 or more ($300,000 with your spouse) over the past two years, and you reasonably expect such income for the current year; or
- your net worth exceeds $1 million excluding the value of your primary residence.

Lack of control. Unlike with property you own yourself, you don't have control over the property in the Delaware statutory trust. Of course, you also don't have the day-to-day landlord headaches.

Leverage. You have heard the saying that you should use other people's money to increase your rate of return. In the real estate investment world, this is common—and it can work. But if you had no mortgage on your 1031 property, you should consider investing in a non-leveraged Delaware statutory trust to reduce the risk that you could lose your investment.

Backup for the 45-day rule. When you have to identify up to three properties under the 45-day rule and then buy one of them within 180 days, you play with fire. Consider naming two properties and using the Delaware statutory trust as a backup. Should the other properties fail, you would use the Delaware statutory trust to preserve your tax-deferred status and live to play the Section 1031 card another day.

Park your investment. If you think the market for buying property will be better seven to 10 years down the road, you could do a Section 1031 exchange into a Delaware statutory trust as a way to "park" your investment.

Takeaways

If it's time for you to get off the landlord bandwagon, the Delaware statutory trust as explained in this article gives you one of several options. It allows you to sell your investment real estate and defer the federal taxes without having to take on the burden of owning and managing a new piece of real estate.

As an alternative to the Delaware statutory trust, you may want to consider

- an UPREIT, as we will explain next in Cashing Out Real Estate Profits without Section 1031, or
- investing in an opportunity zone fund, as we explained in Section 1031 Exchanges vs. Qualified Opportunity Zone Funds: Which Is Better?

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[1] IRC Section 1031(a)(1).

[2] IRC Section 1031(a)(3).

[3] IRC Section 1031(b).

[4] TD 9935.

[5] IRC Section 1031(a)(2).

[6] Rev. Rul. 2004-86.

[7] U.S. Securities and Exchange Commission, Accredited Investor.

Cashing Out Real Estate Profits without Section 1031

Paying taxes on the sale of your real estate is voluntary. You do not need to volunteer.

Real estate investors use Section 1031 to avoid taxes when acquiring bigger and better properties. But now, when you want to cash out, Section 1031 is not the vehicle of choice. So what do you do?

This article gives you three strategies to help you cash out your real estate profits:

1. Use the combination of a charitable remainder trust and a wealth replacement trust to avoid taxes, increase personal cash flow, and increase the estate distribution to your children.
2. Use IRC Section 721 to invest the old property in a real estate investment trust and defer taxes.
3. Use an installment sale to pay taxes slowly.

1. Use Charitable Remainder and Wealth Replacement Trusts

The combination of charitable remainder and wealth replacement trusts can create more estate value for your heirs and cash for you than can selling the property and paying taxes now. The steps that follow explain how this works and how you receive benefits.

Step 1. Donate the property to a newly created charitable remainder trust under terms that grant you and your spouse income from the trust—either a fixed income or a percentage of the trust income—during your lifetimes.[1]

Step 2. Stipulate in the trust that when the second spouse dies, the remaining balance of the trust goes to one or more designated charities.

Benefit 1. More cash is working for you. Had you sold the property, you would have paid taxes and had only the after-tax money to invest.

Benefit 2. You create an immediately deductible charitable contribution.

Limits. The law limits charitable deductions to various percentages of adjusted gross income, depending on the type and nature of the contributions.

Carryover. If the charitable contribution exceeds the limits for the current year,[2] you have five additional years to take advantage of the deductions.[3]

Write-off. Your charitable write-off is based on the present value of the remainder interest you donate to the charity. Tax law gives you life expectancy tables that you use to value the remainder interest and the interest you give away. These are the numbers that give you the value of your charitable contribution.[4]

Step 3. Create a wealth replacement trust.

The wealth replacement trust is a life insurance trust that uses term life insurance with a second-to-die policy that insures both husband and wife. The insurance trust is the

- applicant for the insurance policy,
- owner of the insurance policy, and
- payer of the insurance premiums.

When the surviving spouse dies, the insurance company pays the death proceeds to the insurance trust, which in turn passes the proceeds to the heirs.

Benefit 3. The insurance is the "have your cake and eat it too" part of the strategy.

- Without the insurance, your heirs get nothing.
- With the insurance, you might give them as much as or more than you would without the charitable remainder trust.

Planning tip. To make the insurance part work, you and your spouse must be insurable. If only one is insurable, the plan can still work but generally not quite as well.

Six benefits. Here are six benefits from the combined charitable remainder and wealth replacement trusts:

1. No capital gains taxes on the property transfer to the charitable remainder trust
2. Higher income stream because you invest the pretax value
3. Good-sized charitable deduction
4. Income to pay for the insurance policy
5. Cash to your heirs as if you gave nothing (or little) to charity
6. Big smiles all around as you benefit your favorite charity and heirs while you pay little or nothing to the federal, state, and local taxing authorities

Example. You and your spouse own real estate worth $1 million. If you sell, you would pay $300,000 in taxes to the various taxing authorities. That would leave you with $700,000 that you could invest in certificates of deposit at 2 percent for an annual pretax return of $14,000.

Alternatively, you could create a charitable remainder trust that sells the real estate for $1 million and arranges for a 5 percent return in the investment portfolio of the college that is going to be the recipient of this trust. In this case, the trust creates a

- $94,000 charitable deduction, and

- annual cash flow of $50,000.

From the $50,000 annual cash flow, you take $15,000 a year to fund a $1 million term life insurance policy payable to your children.

Planning tip. Note how this plan adds $21,000 a year in extra income ($50,000 minus $14,000 minus $15,000) and a $94,000 tax deduction for our taxpayer in the example.

2. Use Section 721

Section 721 says that when you contribute property to a partnership in return for a partnership interest, neither you nor the partnership or partners recognize any gain or loss.[5]

Section 721 includes property transferred to an operating partnership (OP) of a real estate investment trust (REIT). In this circumstance, the REIT with its diversified realty holdings becomes the equivalent of a mutual fund in real estate.

The OP units you receive in return for the property contribution entitle you to periodic distributions from the REIT. Further, you may convert the OP units into shares of the REIT.

The REIT investments not only avoid taxes on the transfer of your property but also provide liquidity.

The transfer to a special kind of REIT can solve the problem that triggers tax on a property transferred with a mortgage liability in excess of the property's basis. With the excess mortgage, you recognize gain to the extent of that excess mortgage.[6]

The special REIT, called an UPREIT, is designed to guarantee an equivalent portion of the liabilities of the REIT so as to make the excess mortgage a nonissue and allow you to avoid taxes on the transfer.

3. Use an Installment Sale

A regular installment sale of real estate is an easy way to increase net worth.[7]

Your main benefit of "holding paper" is obtaining a secured note at an interest rate much higher than you could earn from your local financial institution.

In an installment sale, you earn interest on the gross amount because you have not yet paid the taxes. With an installment sale, you pay the taxes as you get paid.

Caution. You pay taxes up front when you have to recapture[8]

- depreciation in excess of straight-line depreciation or
- investment tax credits on low-income or certain rehab properties.

Rule. You make an installment sale when you dispose of property and then receive at least one payment for that property after the close of the taxable year in which the disposition occurs.[9]

Payments you receive in an installment sale consist of three parts:

1. The taxable part of the principal payment
2. The nontaxable part of the principal payment
3. The interest

Example. You sell investment land for $250,000 (net of selling expenses). The land has a tax basis of $125,000. For installment sale purposes, you divide the profit of $125,000 ($250,000 minus $125,000) by the $250,000 net sales proceeds. This gives you a gross profit percentage of 50 percent. Thus, every receipt of principal is 50 percent taxable gain.

At closing, you collect a down payment of $30,000. This down payment is 50 percent return of capital (your basis) and 50 percent taxable gain.

Next, you receive a payment that includes $700 of principal. For tax purposes, you divide the $700 into its 50 percent taxable part ($350) and its 50 percent nontaxable part ($350).

Minimum interest. Tax law requires that you charge a minimum rate of interest on an installment contract equal to the lower of 9 percent or the applicable federal rate (AFR), which the IRS publishes monthly.[10] (For December 2017, the minimum annual interest for a 15-year installment note is 2.64 percent.[11])

Make more money. To make the most money on your owner-takeback installment note, look for the highest interest rate that the seller will pay, and then add points if possible.

Takeaways

Whenever you can, avoid the outright *taxable* cash sale of investment property. To avoid taxes while you build your portfolio of real estate investments, use the Section 1031 exchange.

If you want to cash out, move on, and also take care of your estate, consider combined charitable remainder and wealth replacement trusts.

If the trusts don't grab your fancy, consider the IRC Section 721 REIT and UPREIT strategies to defer taxes on the disposition of your old real estate investment and to gain liquidity.[12]

If you don't mind paying the taxes but would like the tax payments spread out over a number of years, consider a Section 453 installment sale.

You have choices. Pay tax, pay no tax, or pay tax at your own pace.

[1] The percentage is known in tax jargon as a charitable remainder unitrust (CRUT) [IRC Section 664(d)(2)]. Tax law refers to the flat amount as a charitable remainder annuity trust (CRAT) [IRC Sections 664(d)(1) and 453(b)]. A CRAT cannot accept future contributions of property [Reg. 1.664-2(b)]. However, a CRUT can be the recipient of future transfers [Reg. 1.664-3(b)].

[2] IRC Section 170(b)(1)(A).

[3] IRC Section 170(d)(1)(A).

[4] Regs. 20.2031-7A(f); 1.664-4.

[5] IRC Section 721.

[6] IRC Section 357.

[7] IRC Section 453.

[8] IRC Section 453(i).

[9] IRC Section 453(b)(1).

[10] See IRC Sections 483 and 1274; IRS Pub. 537, Installment Sales (2016), Dated January 13, 2017, p 11, says that for sales or exchanges of property (other than new Section 38 property, which includes most tangible personal property) involving seller financing of $5,664,800 or less, the test rate for determining minimum interest cannot be more than 9 percent, compounded semiannually.

[11] Rev. Rul. 2017-24.

[12] IRC Section 721.