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A Real Estate Exit Strategy That Can Save on Capital Gains Taxes

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If you'd like to sell a rental property, business or other highly appreciated asset but are dreading the capital gains, a Deferred Sales Trust may be for you.

There are strategies out there that could save you thousands of dollars in taxes, but you probably won't ever hear about them unless you work with an experienced professional.

The Deferred Sales Trust is one of those. It isn't well known, but it should be. Here's how it works.

We sometimes have clients who own property for a long time, or a business or some other highly appreciated asset, and they're reluctant to sell because of the thousands, or hundreds of thousands, of dollars they will have to pay in capital gains taxes.

They may know about the 1031 Exchange, an excellent tool that allows you to defer paying capital gains taxes on a sale by reinvesting the proceeds into a replacement property. The problem is, some people just don't want to go back into real estate. They've owned property for 20 or 30 years, maybe they were a landlord, and they don't want to do that anymore.

That's where the Deferred Sales Trust comes in. By using Section 453 of the Internal Revenue Code, which pertains to installment sales and related tax provisions, it lets people sell a property or business, defer the capital gains tax and roll the money into investments other than just real estate.

So, let's say you were selling a property for $1 million. Instead of selling directly to a buyer, you would draw up an installment contract with a third-party trust with the promise that it would pay you over a predetermined period. You would transfer the property to the trust, and the trust would be allowed to sell it to the buyer.

Because you sold to the trust in agreement to be paid over time, you wouldn't have to pay taxes on the sale until you start receiving those installment payments from the trust. So instead of having $700,000 or $800,000 left over after taxes, the whole million is there for the trust to reinvest in stocks, bonds, real estate, annuities or any other type of investment that would generate a greater income stream for the trust to pay you under your agreement with the trust.

You can agree to take your payments over a 10- or 20-year period, or over your lifetime. You can even defer your initial payments and not take anything in earlier years if you don't need the income. Meanwhile, the money is invested and growing. All the money, not the money minus the taxes.

If you choose to take your payments over a 20-year period, and structure the payments in your installment contract to be 5% ($50,000 a year), you'll only pay the capital gains taxes on the principal as you receive the money. The IRS code doesn't require the payment of capital gains taxes until you start receiving the installments.

Anyone who has dealt with capital gains taxes knows they can be pretty high: 15% for single filers with taxable income up to $418,400 ($470,700 for married filing jointly), and 20% if you earn more than that. Plus, you'll likely have to pay the 3.8% net investment income tax embedded in the Affordable Care Act. Then there are state taxes to deal with, perhaps another 10%. So now you're talking about approximately 34%, and if you have a depreciation recapture tax, that's another 25% (another 5 to 10 percentage points higher than the typical capital gains tax rate). You could easily be paying — depending on what state you're in — 30% to 40% in taxes when you sell. A Deferred Sales Trust could cut that tax bill in half.

For people who have larger estates, the Deferred Sales Trust strategy also can also be integrated with your estate planning to protect your money from estate taxes.

Sorting through complex tax-deferral and tax-exclusion strategies and structures, tax code changes and new regulations and rulings can be daunting — and if you get it wrong, there are consequences.

Talk to a trusted financial adviser about using this powerful strategy to help grow and protect your nest egg, and review the entire strategy with tax and legal advisers before proceeding.

Kim Franke-Folstad contributed to this article.

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