Selling Appreciated Property

A Summary of Tax-Advantaged Strategies

1031 Knowledge

The Federal Tax Code provides a number of ways for taxpayers to dispose of, exchange or sell an appreciated property and receive tax benefits. Let's briefly go over several of these ways:

IRC Section 121 allows a taxpayer to exclude capital gain taxes (up to $250,000 if filing as a single, and $500,000 if married and filing jointly) following the sale of their primary residence. In order for a property to qualify as a "primary residence," the owner must have lived in the property for two years out of the most recent five year period. Importantly, Revenue Procedure 2005-14 also allows a property owner to convert a primary residence into an investment property, and then later take advantage of both the capital gain tax exclusion under Section 121 and tax deferral under Section 1031 by exchanging into a replacement property held for investment or for use in trade or business.

IRC Section 453 (Installment Sale) allows a taxpayer who sells a property on an installment basis to defer paying capital gain taxes to future tax years *when the installment payments are actually received*. Essentially, in this scenario, the taxpayer provides "seller carryback financing" for the buyer and only pays capital gain taxes as the payments are received over time.

IRC Section 721 provides tax deferral to taxpayers who have a real estate investment trust (REIT) as buyers and the taxpayer contribute their property into a partnership entity to the extent that the contributor receives an interest in the partnership. Certain investment strategies are designed to take advantage of Section 721 such as when to including an operating partnership (OP) created by a REIT sometimes referred to as an "Umbrella Partnership" or UPREIT. In exchange for taxpayer contributing the property to the UPREIT under Section 721, the taxpayer receives units in the operating partnership (OP Units). The capital gain taxes remain deferred as long as the UPREIT holds the property and the taxpayer holds the OP Units.

IRC Section 1031 allows a taxpayer to defer capital gain taxes on the sale of any relinquished property held for investment or for productive use in a trade or business when exchanged for like-kind replacement property to be held for investment or for productive use in a trade or business. Section 1031 can be an extremely useful tool for taxpayers because they can take tax dollars which ordinarily be owed to the IRS and put those dollars toward the acquisition of more desirable investment real estate.

IRC Section 1033 provides tax deferral on the conversion of property destroyed in a casualty event or taken by a governmental entity through condemnation (i.e. eminent domain). To the extent that the taxpayer reinvests the compensatory proceeds for the loss in property that is similar or related in purpose or use, Section 1033 permits the taxpayer to defer recognition of the gain.

A Charitable Remainder Trust permits a taxpayer to contribute appreciated property to a Charitable Remainder Trust (CRT) for the benefit of a designated charity. The contributor (called a donor) receives a charitable tax deduction on the transfer of the property to the CRT. Having acquired the donated property, the trustee of the CRT can sell the property (at no gain to the trust) and reinvest the proceeds in income-producing investments. A CRT is usually designed to pay an annuity to the donor over the course of the donor's life or over the joint life of the donor and the donor's spouse. Any value remaining in the CRT after the donor's death passes to the beneficiary.

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