MINIMIZING THE TAXES ON CAPITAL GAINS AND THE STRATEGIC UTILIZATION OF CAPITAL LOSSES

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ABSTRACT

Taxpayers who sell property under terms that include payments beyond the current year qualify for installment sale treatment under § 453 that better matches the payment of the taxes with the receipt of the proceeds. By itself, the installment sale provisions provide for an opportunity to defer tax liabilities into the future; however, combined with certain other provisions and some advanced planning, the installment method can be leveraged into a significant reduction and in some cases, complete elimination of tax liabilities. This paper examines three situations where the installment sale rules reduce or eliminate the potential taxes created by other sections of the Code.

COMBINING SOCIAL SECURITY AND INSTALLMENT SALE TAX BENEFITS TO AVOID CAPITAL GAIN TAXES

The Farmers:

In 2005, Sam and Sally Farmer reached age 65 and decided that they wanted to retire but were afraid that they would not have enough income because they had no savings or other investments and they still owed $100,000 mortgage on their farm. They were willing to sell some of the 400 acres that they had acquired more than 40 years earlier, but were afraid that federal and state capital gains taxes would consume at least 25 percent of the proceeds from the sale.

If they did not sell any land their expected income was $15,000 in social security benefits and $12,000 in government payments that they could receive by placing most of their land into a government farmland conservation program. However, even after the $12,000 in government payments, the farm would still show an annual operating loss of $5,000 due to interest on the farm mortgage, real estate taxes, repairs and maintenance, utilities, and all of the other miscellaneous costs of taking care of a 400-acre farm property.

Note: Sam's benefit based on the highest 35 years that he paid self employment taxes into the social security system was $10,000 per year. Sally's benefit was based on her spousal status and was 50 percent of Sam's benefit or $5,000 per year.

Note: Farmland owners can receive long-term annual payments from the Commodity Credit Corporation, a U.S. government agency, by planting resource-conserving vegetation plantings. For an overview of these programs see http://www.fsa.usda.gov/FSA/webapp?area=home&subject=copr&topic=crp .

Income from government easement payments	$12,000
Deductible farm expenses	(17,000)
Farm loss	$(5,000)
Social Security benefits	15,000
Remaining cash flows	$10,000

With only $10,000 remaining, in spite of limited personal expenses (no rent or other housing expenses other than the servicing the remaining mortgage and utility bills on the farm residence) the Farmers believed that this would be a difficult budget to live on.

The Farmers received an offer to buy 30 acres of their land that had 800 feet of lake frontage for $6,000 per acre, or a total of $180,000. The land had been purchased in 1955 as part of a parcel of 70 acres for $1,000. Therefore, with an allocated adjusted basis totaling only $400, most of the $180,000 would be subject to capital gains tax. With a combined federal and state rate of about 25 percent, that would cost about $45,000 in tax. The Famers would use $100,000, of the proceeds to pay off the farm mortgage leaving only $35,000 to invest which would produce modest interest income of about $1,000 per year (at current rates). However, without the interest expense on the farm mortgage, the $5,000 farm operating loss would disappear leaving the Farmers with about $16,000 annually to live on ($15,000 of social security plus $1,000 of interest).

By using an installment sale strategy the Farmers have an opportunity to spread the gain over a number of years. When combined with the modest social security benefits and interest income, the Farmers can avoid taxes altogether.

Consider a seven-year installment sale including a 5 percent interest rate. The sale can be structured with a down payment of $30,000 with the remaining $150,000 paid in equal installments over the next 6 years with interest at 5 percent as shown in Table I.

Table I
Amortization of Installment Sale

Year	Principal Balance Before Payment	Total Payment	Payment Applied to Principal	Payment Applied to Interest at 5 %
2005	$180,000.00	$30,000.00	$30,000.00	$ -0-
2006	150,000.00	29,552.62	22,052.62	7,500.00
2007	127,947.38	29,552.62	23,155.25	6,397.37
2008	104,792.13	29,552.62	24,313.01	5,239.61
2009	80,479.12	29,552.62	25,528.66	4,023.96
2010	54,950.46	29,552.62	26,805.10	2,747.52
2011	28,145.36	29,552.62	28,145.36	1,407.26
Totals	$ -0-	$207,315.72	$180.000.00	$27,315.72

During this period, the $100,000 farm mortgage was paid off out of the proceeds of the sale with seven annual payments of about $14,525 leaving about $15,000 available each year for the Farmers' personal

needs. Without the installment sale, of the Farmers would expect to receive about $16,000 each year. Using the installment sale, the Farmers now generate about $25,000 each for their personal needs ($10,000 + $15,000). In both cases the mortgage is paid off and the Farmers arrive at the same financial situation with the exception that the installment sale strategy provides and additional $9,000 of after tax income for their personal needs. The fact that very little tax was paid by utilizing the installment sale strategy is shown in Table II.

Table II
Farmers Federal Tax Returns by Year

Year	2005	2006	2007	2008	2009	2010	2011
Interest Income	$ -0-	$7,500	$6,397	$5,240	$4,024	$2,748	$1,407
Capital Gain (Basis is Assumed to be zero)	30,000	22,053	23,155	24,313	25,529	26,805	28,145
Farm Loss	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)	(5,000)
Taxable Social Security Benefits [see § 86]	250	27	26	27	27	26	26
Adjusted Gross Income	25,250	24,580	24,578	24,580	24,580	24,579	24,578
Standard Deduction (Including "extra" standard deduction for elderly	12,000	12,300	12,800	14,000	14,600	13,600	14,000
Exemptions	6,400	6,600	6,800	7,000	7,300	7,300	7,400
Taxable Income	6,850	5,680	4,978	3,580	2,680	3,679	3,178
Tax	343	284	249	-0-	-0-	-0-	-0-

Note: Up until 2008 the capital gains tax rate for taxpayers in the 15 percent or lower tax rate brackets was 5 percent. After 2007, this capital rate has been held at zero percent and will remain zero until the current law sunsets on December 31, 2012 [See § 1(h)].

Clearly utilizing the benefits of the installment sale provided the Farmers the opportunity to realize their capital gain at a tax cost of under $1,000. This amount is less than the tax they would have had to pay on their social security benefits in 2005, because the inclusion of the entire capital gain would have made 85 percent of their social security taxable resulting in a tax on that income of $1,275 [(15,000 x .85 = 12,750) .10 = 1,275].

Looking at this real life example (fictitious names are used), it is obvious that careful attention to tax planning strategies can greatly increase the financial situation when owners of small family farms and businesses choose to retire. Unfortunately, often, especially in rural areas, this type of professional assistance is either not available or the taxpayers are not aware that they might increase their financial situation by seeking professional advice.

UTILIZING CAPITAL LOSSES TO AVOID THE 25 PERCENT RECAPTURE TAX FROM THE SALE OF DEPRECIATED RENTAL REAL ESTATE

While most taxpayers understand and enjoy the 15 percent maximum tax rate on long term capital gains, many tend to forget that capital gains from the sale of real estate that is attributable to depreciation previously deducted is subject to a 25 percent tax rate. For example, Jason acquired an apartment building on January 1, 2001, at a cost of $3,750,000. The purchase price was allocated $1,000,000 to land and $2,750,000 to the building. As residential rental property the building was being depreciated at the rate of $100,000 each year over a 27.5 year life. On January 1, 2011, Jason sold the building and land for $4,750,000 resulting in a reportable capital gain of $2,000,000 as show in Table III.

Table III
Potential Tax Liability

Sales Price		$4,750,000
Adjusted Basis:		
Purchase Price	$3,750,000	
Depreciation Deductions	1,000,000	2,750,000
Total Capital Gain		$2,000,000
Capital Gain Subject to 25% Depreciation Recapture Rate	1,000,000	$250,000
Capital Gain Subject to 15% Maximum Rate	1,000,000	$150,000

If this was the only capital transaction in 2011, and it was not an installment sale, the capital gains tax would be $400,000 as illustrated above. However, Jason has some almost worthless tech stock acquired during the dot.com bubble in 1999 that he could sell in 2011 and realize a long-term capital loss of $1,000,000. Unfortunately, normally this loss would offset the $1,000,000 of capital gain subject to the 15 percent rate [§ 1(h)] and Jason would still have to pay the $250,000 recapture tax on that part of the gain attributable to depreciation recapture.

By structuring the sale of the building as an installment sale, receiving one-half of the selling price in 2011 and the second half in 2012, the $1,000,000 gain subject to the 25 percent recapture rate will be recognized in 2011 and the $1,000,000 gain subject to the 15 percent rate will be recognized in 2012 [Reg. § 1.453-12(a)]. Then, by selling the tech stock in 2011, Jason would be able to offset the 25 percent gain with the loss from the tech stock, saving $250,000 in 2011. In 2012 he would recognize the $1,000,000 gain subject to the 15 percent rate and pay only $150,000 in capital gains tax.

This strategy can be accomplished because Reg. § 1.453-12(a) provides that, in the case of installment recognition of gain, the 25% gain from the recapture of depreciation come first and the 15% gain comes second. Therefore, taxpayers can use this feature to their advantage by carefully selecting the timing of the gain and the offsetting losses.

STRATEGIC USE OF INSTALLMENT SALE TO MINIMIZE CAPITAL GAINS TAX ON SALE OF SUPER APPRECIATED HOME TO TAXPAYERS CHILDREN

Frank and Julie Homeowner acquired their home in Southern California in 1980 for $200,000. In 2011 when all of their children had graduated from college and were successfully settled in to their careers and families, Frank and Julie, now both age 56, decided that they would like to move to a smaller more modest house and prepare for their retirement in ten years, when they would reach their normal retirement age of 66. Fortunately the Homeowners had been able to pay off the mortgage during the thirty years they spent raising their family in the home; therefore, their equity was 100 percent of the $1,200,000 current market value. Additionally, their daughter Susan and her husband, who had just added a set of triplets to the twins that had been born two years earlier, expressed a desire to buy the home for their now large family, provided that they could get some help with the financing.

A major problem facing the homeowners was that, although they met the requirements for excluding $500,000 of the gain [§ 121], the other $500,000 of capital gain would be subject to 15 percent federal and approximately 10 percent California capital gain taxes resulting in a $125,000 reduction to their equity. Additionally, investing the proceeds in Treasury bonds or CDs would only yield about 2 percent at current interest rates. Therefore, the Homeowners sought professional advice from Joe Honest, a financial planner and tax professional with a sterling professional reputation in their community.

Mr. Honest proposed that they structure the transaction as an installment sale that would: allow the daughter to acquire a bank first mortgage as a desirable interest rate, receive a 4 percent interest rate on their investment, and avoid the entire $125,000 capital gain taxes.

Note: Installment sales are allowed between family members. However, the property must not be resold in less than two years, or the installment sale will be nullified to some extent [§ 453(e)].

Because the Homeowners needed only the $600,000 from the proceeds of the 3.85% 30 year fixed rate first mortgage to buy their modest retirement home, they decided to take a $600,000 second mortgage for the second half of the purchase price. The second mortgage was structured to pay only the 4 percent interest for 10 years; then the $600,000 principal would be amortized over the remaining 20 years with payment totaling $44,150 each year, about $40,000 of which would be taxable income either as interest or long term capital gain. The balance of their $100,000 total annual retirement income would consist of $20,000 taxable pension benefits and social security benefits of $40,000. Because of the amount of their other income, 85 percent ($40,000 x .85 = $34,000) of the social security benefits would also be taxable. Therefore, the Homeowners adjusted gross income would be approximately $94,000 each year. Assuming a 2 percent inflation adjustment to the Homeowners' standard deductions and personal exemptions, in ten years these would be about $17,000 and $9,000 respectively bringing their taxable income down to about $68,000 placing them into the 15 percent marginal tax rate. Therefore, if the current zero capital gains tax rate for taxpayers in the 15 percent or lower tax bracket is extended in to those future years, the Homeowners would pay no tax on the second $500,000 of capital gain on the sale of their home. At this time, both political parties support the extension of this tax break for middle-income taxpayers.

This strategy should have the result of eliminating all capital gain taxes on the entire $1,000,000 long-term capital gain from the sale of the house. The $500,000 recognized in the year of sale would be

excluded under § 121. The $500,000 recognized during the retirement years would be subject to the zero tax rate under § 1(h).

In the event that the Homeowners both die before the second mortgage is paid off, their children may inherit the note, becoming both payees and payers. In such an event, the note is deemed to be collected at its remaining face value [§ 453B(f)(1)], triggering recognition of any remaining gain that is taxable to the decedent's estate [§ 691(a)(2)].

CONCLUSION

Because Congress passed into law many features of our federal income tax without considering their interdependence with other features of the tax Code, careful strategic planning can, at times, use one feature to minimize or eliminate the tax that another feature was supposed to extract from the taxpayers. In this paper we have demonstrated how the installment sale features can be combined with three different areas of the tax Code to, in some cases, eliminate, or at least minimize, the intended tax.