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CAPITAL GAINS TAX DEFERRAL: Concept Overview

A TAX DOLLAR DUE IN 30 YEARS

ASSUMING A 6% RETURN

IS VALUED AT ONLY $.17 CENTS ON THE DOLLAR

A DISCOUNT OF 83%

The Capital Gains Tax Strategy is available to any one selling an appreciated capital asset, including their personal residence.

What is the Capital Gains Tax Strategy and its objective?

The strategy employs the tax regulations related to an installment sale under Section 453. The primary objective is to defer the capital gains tax liability for thirty years, providing the seller an opportunity to have the tax dollars available for investment or personal enjoyment today.

What are the financial benefits to the Seller?

Capital gains are taxed at federal rates of 20% to 28%, plus a state (California) tax rate of 13.3%, and may be subject to the net investment income tax rate of 3.8%. Combined the tax on the sale of an appreciated asset could be taxed at 37.1% to 45.1%

The seller through the strategy can defer the tax for thirty (30) years, paying the tax in future dollars which are substantially lower than paying in today's dollars due to inflation. The present value of the future tax liability assuming a 6% inflationary rate is seventeen cents on the dollar- a steep discount of the tax liability. Another way of viewing the tax savings benefit is how much would the tax savings grow, if invested at a return of 6%- which would result in over five times the tax savings- so 1$ million of tax savings would grow to $5.7 million over the thirty years.

How does the strategy work?

The strategy requires that there be a Qualified Dealer having a lender relationship. The buyer will not be affected or see any change to the terms and conditions of the escrow and sale contract.

An installment sale through a "Qualified Dealer" with an established "Lender relationship" provides the seller 90% of the cash proceeds at closing through a tax-free monetization loan (non-recourse), at no net cost to the Seller for interest or principal payments. This does not alter or change the Seller/Buyer escrow, and there is only one transfer of title as the deed or other instrument of transfer will pass directly (in a "directed transfer) from Seller to Buyer.

The cost of the transaction is the difference between the selling proceeds and the monetization loan at 90%, or a net cost of 10% of the selling proceeds.

What are the tax characteristics of the strategy?

There is no specific tax ruling but substantively there is in the form of the IRS Office of Chief Counsel Memorandum No. 20123401F, released August 24, 2012 which approved the tax deferral for an installment sale under Section 453 when the installment sale was coupled with a monetization loan.

What assets can be sold and benefit by the tax deferral strategy?

Any capital asset can qualify for the tax deferral benefit, including the sale of your personal residence, commercial real estate, business stock ownership and goodwill, art; with the only exception being marketable securities.

The benefit of the Capital Gains Tax Strategy can be substantial to the Seller in providing 90% of the sale proceeds tax-free, with deferral of the Capital Gains Tax for Thirty (30) years.

What is the tax reporting attributable to the transaction?

Interest paid on the installment note is reportable as income to the taxpayer (seller) on a form 1099 from the Qualified Dealer, who makes the payment to an impound account. The lender bank is paid the interest on the loan from this impound account, and provides a statement of interest paid to the taxpayer (seller). Interest income and interest expense will be the same. Interest paid to the Lender Bank is deducted as investment interest expense, offsetting the interest income on the installment note. There is no tax cost or expense to the seller.

What is the term of the loan and am I liable to the Lender Bank?

The loan term is for thirty (30) years at a fixed interest rate. The seller is not liable for repayment of the loan (it is non-recourse) or the interest payment. The interest payable is satisfied through an impound account collecting the interest income on the installment note to pay the Lender Bank loan interest. The Qualified Dealer is liable for the payment of the interest and the principal loan payoff upon maturity

What happens if I die before the loan matures- will the loan be called?

No. The loan is for thirty (30) years and will continue and become a liability to your estate (heirs).

When do I decide on whether to employ this strategy?

Once you have opened escrow for the sale of your capital asset. The documents (escrow agreement and contract of sale) are sent to the Qualified Dealer, who will prepare supplemental agreements to be sent to you. All terms and conditions are fully transparent and subject to your review, and the review of your tax and legal advisors. There is no obligation on your part to execute the documents. When completely satisfied, your execution of the documents will create the transaction to defer your capital gain taxes. The Buyer will not be affected. Title will transfer in accordance with your escrow and contract of sale.

Is there any minimum or limit on the amount that can be deferred?

Yes. The minimum selling price must be at least $500,000. The maximum installment note a taxpayer may hold in any given tax year is $5 million, or if filing jointly it is $10 million. Above 10$ million the IRS must be paid interest on the amount above this threshold. There are alternative methods to structure the transaction if it is above $10 million, but generally this is the maximum.

What happens if the Qualified Dealer becomes insolvent or bankrupt?

Should the Qualified Dealer go out of business or become insolvent, and unable to pay off the principal loan there would be no recognition of the capital gains tax. There is also no loan forgiveness to trigger income taxation. This would be a beneficial outcome to the Seller.