

# CAPITAL GAINS TAX PLANNING STRATEGIES



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# FOURTEEN STRATEGIES TO ELIMINATE OR DEFER CAPITAL GAINS TAX

Capital gains tax is due whenever an asset is disposed of. The tax bite can be significant for assets that have been owned for a significant amount of time. Avoidance can take two forms. One is elimination of some or all of the tax that would have been due, meaning it never has to be paid. The other is deferral which means that the tax is still due at some point, just not now. That is better than it sounds for a few reasons. Money you don't have to pay today is available to be reinvested for your benefit. Secondly, someday you may be in a position to get out of paying the tax permanently. Finally, you may be able to time the eventual payment of tax in a year when your income and tax bracket is lower allowing you to pay less tax. Maximum capital gains rates are currently 20% on federal (long-term) and 13.3% on California, for a total of 33.3%, although most taxpayers are subject to lower marginal rates.

## Sale of principle residence exclusion – IRC Section 121

The sale of a qualifying principle residence is completely or partially tax-free. For couples filing jointly, the exclusion amount is \$500,000, for all others, it's \$250,000. That means you can make that much on the sale without paying tax. For example, if you're married filing jointly and you purchased your home for \$250,000 and sold it for \$750,000, no tax would be due as the gain is \$500,000. If you sold it for a million, tax on \$250,000 would be due. The primary requirement is that you occupied and used the home as your principal residence for 2 out of the past 5 years. Rental property and vacation homes do not qualify.

## Like-kind exchange – IRC Section 1031

The like-kind exchange is a well-known tax deferral method. The idea is if you rollover the proceeds from one property into another of the same type, the gain (and tax) is deferred. There are several restrictions on this transaction. It is usually done with the assistance of a tax professional and an intermediary called an “accommodator”. They retain the funds until needed for the new property. If the owner takes possession of the funds, this technique is no longer an option. For full deferral, the new property must cost as much or more than the old property.

There are two basic methods to form the replacement property. The first is the traditional method of purchasing replacement real estate. That works fine for those who wish to continue being a landlord or owning similar property. If your preference is to not deal with direct real estate ownership, a Delaware Statutory Trust (DST) might make more sense. This is a Real Estate Investment Trust (REIT) set up to receive 1031 rollover funds. In this way, you get the tax benefits of the 1031 while getting the benefits of professional management and diversification.

Delaware Statutory Trusts (DST) that are properly structured are recognized by the IRS as qualified replacement property for real property. Investors in a DST are not direct owners of the real estate. The trust holds title to the property, for the benefit of many investors, each of whom have a “beneficial interest” and is treated as owning an undivided fractional interest in the property.

Simply put, DSTs provide a turn-key solution for investors who may not have the time, energy or real estate expertise to find and/or manage a replacement property. DSTs can be used for all or a portion of the sales proceeds. Also, be mindful that there may be fees and expenses associated with a DST.

With its unique structure, a DST can offer you many benefits:

- Access to institutional-quality real estate
- Professional asset and property management
- Passive ownership
- Non-recourse institutional financing
- Lower minimum investments
- Portfolio diversification
- Ability to close quickly

## Installment sale – IRC Section 453

An installment sale is when you finance an asset you sell, also known as owner financing or “taking back paper”. When this is done, the law allows the taxpayer to choose when to pay tax. They can take the hit in the year of sale or, at the taxpayer's option, it can be claimed as the principal is received. Spreading it out has two benefits – one is simply delaying the payment of tax so that the funds can be invested. Secondly, it may keep the income reportable in any one year down, possibly allowing a lower effective tax rate to be applied. Why would anybody opt to pay it in the year of sale? It's simpler as you don't have to report it every year and income may be expected to be higher in subsequent years.

## Deferred sales trust – IRC Section 453

This is similar to the installment sale – it looks and acts exactly as an installment sale on the tax return. But it doesn't require financing the property. Perhaps you don't want the risk associated with default or don't want the hassle of collecting on a note. Once a buyer is found, you create a trust and “sell” the property to the trust on an installment sale. The trust then sells the property to the buyer for cash. This is not as common as other methods as it entails cost and accounting overhead.

## Monetized installment sale – IRC Section 453 and 453A

This is a complex arrangement that is most often used by corporations for very large transactions. However, it is available to any taxpayer with a gain large enough to justify it.

The idea is you “sell” the property to an intermediary – usually a trust company for 95% of the sales price – you receive that immediately and free of immediate tax. It is tax free because it is legally a loan. The intermediary then sells the property to the seller for cash. For the next 30 years, the intermediary makes the loan payments (interest only). At the end of 30 years, the whole thing terminates and the tax becomes payable at that time.

The remaining 5% is retained by the intermediary as a fee for services. So, the net effect is that for the foreseeable future of 30 years, the seller is only out the 5% instead of up to 33% tax. That money can be invested and it would net out to far more than the 5%. The 5% is not set in stone. It's what's most often discussed, but it's negotiable and will be different for different providers. A quote I received recently was 7%.

## Opportunity zones – IRC Section 1400Z

Opportunity zones (OZ) are the newest method. It's been getting a lot of attention because put simply, it's a really good deal.

Created by the “US Investing in Opportunities Act”, which is part of the new tax law, it is intended to encourage investment in low income communities. California alone has 879 census tracts that have been identified as OZs. There are 8,762 nationally. So, there is plenty of places to look to find OZ investment opportunities. The most common way to invest in an OZ is through an OZ fund. This is a fund of money pooled from many investors with the intent of profitably investing in OZ qualified projects.

There are several tax benefits to OZ investments. The first is that taxable capital gains can be rolled into it. There is no requirement that the full sale price be rolled in as is the case with 1031s – your principle (basis) can be retained tax-free. You can also roll in depreciation recapture which can be a real benefit for property that has had a lot of depreciation claimed.

Additionally, investments held 5 years gets a 10% step-up (discount on tax) and 7 years gets 15%. This presents a bit of a challenge as the way the law is presently written, tax becomes payable and the holding period for this purpose ends on 12/31/2026. If you work backwards from that date for 7 years, you'd have to have made the investment by the end of 2019 to get the full 15%. That's ok as the tax law could change, extending the window and even if it doesn't, 10% on top of the other benefits is still pretty good.

Finally, if you hold the investment for 10 years, which you should probably plan on if you want to receive maximum benefit, you receive all earnings from the investment free of tax. You still must pay on 85%-90% of the original gain, but what you make on the OZ investment itself is free of tax. As an example, say you invest a million dollars and it averages

7% for 10 years (There is no guarantee of what actual returns will be). Your investment would roughly double. At the end of the day, you made a million dollars free of tax. That's up to \$333,000 in tax savings for California taxpayers at today's rates.

## POTENTIAL TAX ADVANTAGES OF INVESTING IN A QUALIFIED OPPORTUNITY FUND

SCENARIO: HYPOTHETICAL AFTER-TAX VALUE <sup>1</sup>		Non-Qualified Opportunity Fund	Qualified Opportunity Fund <sup>2</sup>
\$1,000,000 INVESTMENT OVER 10-YEAR HOLD (assuming hypothetical 7% compounded rate of return on both investments)			
<p><b>Investors may pay as little as \$0 in capital gains on the next decade of investment returns.</b></p> <p><sup>1</sup> This illustration assumes the investor is subject to the top marginal U.S. federal income tax rate of 20% on long term capital gains for individuals, the net investment income tax of 3.8% and a state tax of 6.2% for a total tax liability of 30%. No brokerage or investment advisory fees are accounted for with respect to the Non-Qualified Opportunity Fund example above and no distributions made on the Class C common stock, no fees due to our Manager and its affiliates and no sales commissions, deal manager fees and non-accountable diligence and marketing allowances due to our Managing Broker-Dealer and its affiliates are accounted for with respect to the Qualified Opportunity Fund example.</p> <p><sup>2</sup> This illustration assumes that the Qualified Opportunity Zone investor is a resident of a state that conforms with the QOZ Program.</p> <p><sup>3</sup> Assumes that the investor has no capital losses to reduce such capital gain and refers to the inclusion of the original, invested capital gains in such investor's taxable income on December 31, 2026.</p> <p>This example assumes the investor does not pass away during the ten year period. If the investor were to pass away, the heirs receive a step-up in basis in the Non-Qualified Opportunity Fund example and a carryover basis for the Qualified Opportunity Fund example.</p>	ORIGINAL CAPITAL GAIN <i>from sale of prior investment</i>	\$1,000,000	\$1,000,000
	TAX RATE	30%	30%
	TAX ON ORIGINAL CAPITAL GAIN	(\$300,000)	Deferred
	INVESTABLE AMOUNT <i>after tax</i>	\$700,000	\$1,000,000
	COMPOUNDED HYPOTHETICAL ANNUAL RETURN	7%	7%
	APPRECIATION <i>over 10 years</i>	\$677,006	\$967,151
	TAX ON APPRECIATION <i>after 10 years</i>	(\$203,102)	\$0
	LONG TERM CAPITAL GAINS TAXES PAID <sup>3</sup> IN 2027 <i>on original capital gain</i>	\$0	(\$255,000) <i>30% of \$850k, basis stepped up 15%</i>
	TOTAL GROWTH ABOVE ORIGINAL CAPITAL GAIN <i>After 10 years, net of taxes paid</i>	\$173,904	\$712,151

## Charitable remainder trust – IRC Section 664

Charitable remainder trusts (CRT) allow you to turn a taxable event (capital gains) into a deduction (charitable contribution) while creating an income stream for yourself. It is complicated and requires a trust attorney and a trust company to administer it, so the \$125,000 is a big enough gain to justify the transaction, no need for the cash proceeds and a charitable intent. It's probably not something that would make complete sense if the taxpayer doesn't have a desire to benefit a charity.

## Step-up in basis – IRC Section 1014(a)

The self-made billionaires in our country will never pay income tax (they'll still pay estate tax) on almost all of the money they have made. The reason is the step-up in basis. You don't have to be a billionaire to benefit from this.

The step-up in basis gets you off the hook forever for all capital gains with one big requirement. You have to die. Death is a life event that needs to be planned for if you want to maximize the impact your financial assets can have for heirs. When a person passes away, the assets they leave before get a "step-up in basis" which means that the price paid for tax purposes becomes equal to the value at the date of death.

As an example, say you bought a piece of land in 1960 for \$5,000. Today, it's worth a million dollars. If you were to sell, tax on \$995,000 would be due. If you pass away and leave the land to your kids and they sell for a million dollars, the purchase price (basis) would get stepped up to a million dollars. \$1,000,000 - \$1,000,000 = 0, so tax would be 0.

This is the reason you should NEVER put your kids name on your appreciated real estate. That is considered a gift and gets no step-up. The right way to pass on real estate is with a living trust.



## Other strategies

This isn't an exhaustive list of ways that you can plan around capital gains tax. I focused on actual strategies that need explaining. Other ways to avoid tax are easier to understand and require less planning. Some of these are 1) Gifting appreciated assets to family members in a lower tax bracket 2) Timing sales for when there are deductible capital losses 3) Timing sales for when income is lower 4) Donating the asset to charity – provides a double benefit. First, the capital gain doesn't get taxed and second, a full deduction for the value is allowed. 5) Investing through a self-directed Roth provides for tax-free earnings and 6) Borrowing against the property. Loans are not taxable.

## Conclusion

My goal was to present several capital gains tax planning strategies with enough information to give you a feel for how they apply and how you may be able to benefit from them. Our financial lives and our investments are complicated, and no two families are the same. What might work for one may be completely inappropriate for another. In reality, there is far more to the application and implementation than I described here.

I have been helping clients with difficult tax situations for 34 years. I enjoy tax law and helping people navigate it. Please feel free to reach out to me with any questions you may have via email, telephone, or call for an in-person appointment. There is no fee for initial consultations.



## ENSEN MASON CPA, MBA, CFA

Ensen Mason is both a licensed accountant (CPA) and investment advisor (CFA & IAR). Since starting his practice in 1988, he has personally prepared over 10,000 income tax returns. Between the various investment roles he has, he personally manages or oversees \$20 billion in investment assets. Mr. Mason prides himself on personally knowing his client's unique financial situation intimately so that he can provide the advice that gives his clients the best outcome. He understands each family's situation is different and no one product or solution is right for everybody.

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