

## The Wealth Preservation Strategy—A Way Out

Those of us who own highly appreciated asset like homes, commercial real estate, stock portfolios, or businesses are often reluctant to sell because of the capital gains and depreciation recapture costs associated with the sale.

How many times have you heard this?

*“I have a commercial property I would love to sell, but capital gains taxes would kill me”*

*“I’d like to move out of the landlord business, but with the capital gains tax hit, what other choice do I have?”*

*“Sure it would be nice to sell when I can lock in my appreciation, but after the government takes their share and makes me repay depreciation, is it really worth it?”*

Sound Familiar?

Fortunately, there is *a way out*—a smart and financially sound way to address these issues. For many of these tax scenarios, the answer may lie in the Wealth Preservation Strategy (WPS).

The Wealth Preservation Strategy allows a seller to defer capital gains tax at the time of the sale. There is no maximum on the size of the transaction. The Strategy can be used on any kind of sale that generates a capital gains liability including the sale of a primary residence, rental properties, vacation homes, commercial properties, hotels, retail developments, strip malls, and even raw land to name a few.

### A Closer Look at Capital Gains Taxes

As you well know, capital gains taxes can run from 15 to 25 percent (depending on the state). Then, if there is depreciation recapture on the sale, the federal rate of 25% can make this expense even higher than the capital gains tax.

Even on a primary residence, with the growth of equity accumulated over the years, there may be a hefty tax surprise when the property is sold (even after considering the \$250,000 exemption per individual).

This still isn’t the end of the story.

The capital gains amount must also be added to the sellers adjusted gross income (AGI). This means that capital gains or profits may raise the “floor” above which one can take a number of itemized reductions, resulting in a large decrease or total loss of these deductions. This combined

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impact often makes the effective, but hidden, capital gains rate much larger than federal and state income tax rates.

Then, to make matters worse, the capital gain and depreciation recapture taxes must be paid within ninety days of the sale of the asset.

### **Wealth Preservation Strategy Scenario**

Now you can see why the Wealth Preservation Strategy becomes such a valuable strategy for sellers faced with this dilemma.

In the following example, the process starts when a property owner transfers ownership of their property into a Special Trust created just for that client.

In our example, the asset is worth \$1,000,000. The seller has selected one their heirs to be trustee.

Next, the trust “pays” the seller for the property pursuant to specially created contract.

A Wealth Preservation Strategy sale is similar to an installment sale.

The payments may begin immediately or may be deferred for months or even years. Deferral is strictly an option.

It is important to understand that payment of the capital gains tax is handled like an “easy installment plan” You only pay capital gains on the taxable amount of the incremental income of tax. This is like receiving a tax-free loan from the IRS.

On top of that, the tax payments will be made with depreciated dollars due to inflation, while the investment money in the trust will likely grow at a rate greater than inflation.

Now, let us examine some numbers and compare the Wealth Preservation Strategy.

In our example, the property is valued at \$1,000,000. The seller’s basis is \$200,000, leaving a profit of \$800,000. We are estimating a combined federal and state capital gains tax rate of 20% that yields \$160,000 if taxes. This leaves a net cash amount of \$840,000 in the normal sale compared to \$1,000,000 in the Wealth Preservation Strategy.

We are assuming the money invested in both cases earns a conservative 6% before income taxes for the next 20 years (the property owner is 45 and chooses to start receiving payments at 65). Under the normal sale, the property owner receives annual payments of \$277,300 vs. \$330,119 under the annuity plan. This yields an estimated life payout of \$5,546,000 under the taxed plan vs. \$6,602,380 with the Wealth Preservation Strategy.

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This is a \$1,056,380 advantage to the seller due to the larger amount of net cash that was initially invested.

**Recap:**

	<b>Normal</b>	<b>PAT</b>
Selling Price	1,000,000	1,000,000
Basis	200,000	2,000,000
Profit	8,000,000	8,000,000
Capital Gains Taxes	160,000	Deferred
<b>Net Investment Cash</b>	<b>840,000</b>	<b>1,000,000</b>
Assumed Growth Rate	6%	6%
Seller's Age	45	45
Deferral Period	20 years	20 years
Annual Payout (65+)	277,300	330,119
Est. Life Payout	5,546,000	6,602,380
<b>WPS Advantage</b>		<b>1,056,380</b>

**Depreciation Recapture**

We have primarily focused on capital gains tax. However, some of the depreciation recapture taxes are also deferred with a Wealth Preservation Strategy.

Also, installment sales have “related party” rules that prevent an arrangement such as the WPS described above. The related party rule will only permit an installment sale with an outsider while the WPS allows an arrangement with a family member.

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## **Investments**

There is substantial flexibility in making investments with the trust's funds. The money may be invested in securities, real estate, or even in a new or existing business.

The primary requirement of the trust's investment program is simple to produce the necessary cash flow to be able to make the contract payments.

## **Additional Benefits**

The Wealth Preservation Strategy also offers the following significant benefits:

What is left in the trust at the time of the seller's death will pass to the beneficiaries completely free of estate and gift taxes.

This arrangement does not trigger any gift tax consequences no matter how much the property is worth.

The property will not need to go through probate when the seller dies.

The formal mechanics of the trust provide the discipline that some find helpful in providing for their own retirement.

The Wealth Preservation Strategy works equally well for single or married sellers. Married couples can have the contract written as a joint, last to die contract.

## **WPS vs. Charitable Remainder Trust**

In the WPS, nothing needs to be given away to charity as is required with a competing strategy known as the Charitable Remains Trust.

The Wealth Preservation Strategy allows all principal and accrued interest to be paid to the seller, whereas the Charitable Remainder Trust pays the grantor income (interest) only. In virtually all cases, the WPS yields more bottom line dollars than the Charitable Remainder Trust.

As illustrated above, The Wealth Preservation Strategy has the ability to generate substantially more money over the long run than a direct and taxed sale. It is also superior to the Charitable Remainder Trust and installment sales in many respects.

## **Frequently Asked Questions**

Q. Is this plan flexible—can contract payments vary over time?

A. Yes.

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Q. Can I cancel the Wealth Preservation Strategy sales contract after a few years and get my money out?

A. If all the parties agree, you may terminate the trust and get the cash out. However, you would owe all the taxes, plus penalty and interest, on the full amount of cash you received.

Q. Can the trust buy property at a later date?

A. Yes, the investments of the trust are extremely flexible. The seller can even borrow from the trust. However, the trust must be able to make the payments scheduled in the contract.

Q. What happens if the trust goes broke?

A. With bad luck or poor investment this could happen. In that case, there would be no further tax liability. You obviously cannot be taxed on money you do not have.

Q. When the property sells, may I keep some of the cash from the sale?

A. Yes, in that case you would pay taxes only on the portion of the money you kept.

Q. I would like my tax advisor and attorney to analyze the Wealth Preservation Strategy.

A. We will gladly provide your tax advisor or attorney with the technical and legal information he/she needs to evaluate the plan.

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