ASSET RICH, CASH POOR:

How to Get Liquid Without Drowning in a Sea of Taxes

BY KRISTI MATHISEN, JD, CPA, PFS

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Wealth is often held in things that can't be bought and sold easily – a remote family estate, farmland, commercial and rental real estate, or even an art collection. The values of many "illiquid" assets have soared in the past decade, yet the owners may see them as a burden. Maybe they don't generate enough cash. Or the property could be a hassle to maintain.

What's a "cash poor" person to do? Many don't do anything, fearing the taxes. Having seen these situations play out over the years, I can tell you that putting taxes first is not a good approach. Instead, focus first on what it is you want. Then work back from that to minimize taxes (see box below).

SPREAD OUT THE PAYMENTS

Perhaps you want to convert that illiquid asset into a series of payments. This can provide income for retirement or other needs and could also break down a big capital gain into smaller amounts taxed at lower rates (see box below). If this sounds good, here are two options:

1. **Set up an installment sale.** Installment sales, with payments to you over more than one year, are useful ways to sell real estate, business interests or collectibles like art. The strategy here is to spread out the capital gains, so you end up paying less tax over time.

   EXAMPLE: Martha and George agree to sell their Orcas Island vacation property to a neighbor for $1 million (gain is $900,000). The terms: $100,000 down and $92,700 a year for 15 years, reflecting a 6% interest rate.

   If Martha and George keep their annual income below $250,000, they pay a capital gains rate of 15% on the payments (except for the year of the down payment) and avoid the 3.8% tax on investment income. Over the 15-year contract, they will collect $490,000 plus the $1 million sales price.

   DISADVANTAGES: Capital gains rates could rise during the payment period. If the buyer

GOOD TO KNOW: YOUR CAPITAL GAINS RATE

Capital gains rates vary depending on your income:

15% — if your taxable income is below $479,000 (married filing jointly) and $425,800 for singles.

20% — if your taxable income is above these levels.

PLUS, a 3.8% surtax on capital gains and other your investment income if: Your gross annual income is above $250,000 married ($200,000 single).

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defaults, you must go to court to collect (this is why the interest rate on installment sales is usually higher than market). And, once payments end, you must be ready for the big decrease in cash flow.

2. **Put the property into a charitable trust.** The trust can sell the property tax-free and pay you or someone else a fixed amount each year (annuity) or a variable amount (a set percentage of the value of the trust, which will hopefully increase over time). At the end of the trust term, whatever is in the trust goes to a charity you specify when the trust was set up.

EXAMPLE: Martha and George transfer their $1 million Orcas Island property to a "Charitable Remainder Unitrust" that pays them 7% ($70,000 to begin with) as long as one of them lives. For that year, they get a $217,000 charitable deduction (based on $1 million in value and April 2018 interest rates). The trustee can then sell the property to the neighbor or whomever pays the best price. George and Martha will pay tax on any trust payments, which will include both capital gains (from the sale of the property) and investment income.

THE ADVANTAGES OF A CHARITABLE TRUST: It lets you lock in a profit without having to pay capital gains taxes upfront. You can opt to receive the income from the trust or transfer that income to a family member as a gift. A charitable trust is flexible; it can be a good solution for income-producing property, such as apartment buildings, as well illiquid assets like raw land or art.

NEED MORE CASH?

Perhaps you need more cash out of the property right away. These strategies are then worth considering.

1. **Make that property your principal residence, if possible, then sell it.**

TWO REASONS: **1)** The cost of major improvements to a principal residence can be added to the purchase price, reducing the amount of profit from a sale. **2)** When you sell a principal residence, you can exclude up to $500,000 in profit ($250,000 if single). Gains over that amount are taxed at 15% or 20%, depending on your income (see box on previous page).

BEWARE: To qualify as a principal residence, you must have lived in the property for at least 2 out of the 5 years before the sale. If the property has not always been your principal residence, the exclusion may be limited.

OTHER CAP GAINS RATES

Art and most collectibles: taxed at a special 28% tax rate, plus the 3.8% surtax, if the taxpayer's annual income exceeds $250,000 for married filing jointly ($200,000 for singles).

Depreciation on real estate sold: This portion of a gain is taxed at 25%.

IN DEATH DO GAINS PART

When the property owner dies, the tax basis of his/her property is adjusted to fair market value.

What this means: If your land is worth $1 million when you die, it does not matter that you paid only $100,000 for it. Your heirs will inherit it with a tax basis of $1 million. They can then sell at no gain, essentially tax-free.

In Washington State and eight others (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Wisconsin), the death of one spouse triggers the tax basis step-up on all of the community property. That means the surviving spouse can sell the property tax-free.

HERE'S HOW THAT WORKS:

EXAMPLE: Martha and George rented out the vacation property on Orcas Island for five years. They then lived there for the next five years and sold it for a $600,000 capital gain. Instead of the full $500,000 exclusion, they get only $300,000 (half the gain, since it was a rental half the time). Had the gain been $1 million, they would have benefited fully from the full $500,000 exclusion.

2. **Borrow against the property and/or rent it.** At today's relatively low interest rates, a new mortgage or a refinance can allow you to take out a substantial amount of cash. (NOTE: If the money borrowed is not used for an investment or home improvements, the interest may not be tax-deductible.) Annual loan payments will be required. So you could decide to rent the property, if that covers the carrying costs (mortgage, taxes, insurance and maintenance).

TRADING PLACES

A "like-kind exchange" does not allow for any cash out, but it does put off taxes.

The new tax law passed in 2017 limits like-kind exchanges to real estate only. Generally, all real estate is like-kind if located in the US. As long as the properties exchanged are "like-kind" real estate (business or investment property), the exchange is tax-free.

EXAMPLE: Martha and George refinance their place on Orcas and take out $300,000 in cash to buy a farmhouse in upstate New York. They then rent out Orcas for $40,000 a year, as a corporate retreat, to cover the $30,000 in carrying costs.

What about a reverse mortgages? If you're 62 or older, a "reverse mortgage" lets you convert some of the equity in your primary residence into cash or do away with future mortgage payments. The downside of reverse mortgages: The amount you can borrow is limited and you cannot change the use of the property (rent it out).

THE BOTTOM LINE

Because each situation is unique, the above strategies are just general examples, meant to show that there are many options when it comes to illiquid assets. We can help you fully explore all these and more options so you can do what will work best for you. We have been advising large property owners and investors for more than 50 years, helping them achieve their goals while protecting and growing their wealth.

ABOUT THE AUTHOR

KRISTI MATHISEN is managing director of tax and financial planning at Laird Norton Wealth Management. In addition to being LNWM's in-house expert on tax and estate planning, she provides advice on philanthropic strategies to the firm's client service team and to clients directly. Kristi is an attorney and CPA with more than 25 years of finance-related experience, much of it in accounting. She has a bachelor's degree in business administration with an accounting concentration from the University of Washington and a Juris Doctor from the University of Washington School of Law. Kristi is a member of the Washington State and King County Bar Associations, the CPA Society of Washington State and the American Institute of CPAs.

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