1031 Exchange *Or* Monetized Installment Sale (MIS)?

Taxes. A constant reality that we have to deal with. They are necessary. But one thing I've learned, Uncle Sam is not our Uncle. Therefore, I only want to give Uncle Sam what is rightfully and lawfully his and keep what I can rightfully and legally keep. Basically, I'm all about tax avoidance but not tax evasion.

In the world of real estate, many property owners are sitting on a highly appreciated asset. For many of them, their desire is to either sell the asset and leverage the current value to attain another asset that will create more cash flow, or simply put, they want an exit strategy without having to pay the capital gains and recapture taxes the following April.

In this article, I'm going to explain some of the primary differences between a 1031 Exchange and a Monetized Installment Sale. I am not going to go through the tax code. We teach seminars and webinars on both topics as well as many other professionals that do the same. There are plenty of opportunities to learn the tax codes and mechanics associated with the two strategies. This is based on an assumption that one understands the code and the mechanics of each.

Value of 1031 Exchanges

1. **Familiar tax strategy.** 1031 Exchanges have been occurring for nearly 100 years. After the Starker Case in 1979, the 1031 Exchange became more regulated. It gained more momentum and exposure as a tax strategy. That was 41 years ago. Now, it is a very commonly discussed tax strategy. Basically, it's a "household name" among investors. That means that people, generally speaking, are going to be more comfortable with using this tax strategy.

   For those who want to read about the case, here's a good link. It makes for a great late night sleep aid:-).

   https://www.timbertax.org/research/caselaw/court_cases/s/starker1/

2. **More affordable.** I do not know what exchanges cost throughout the U.S.. From what I do gather, the range is from $600-$1200 for basic exchanges. A monetized installment sale is going to cost about 6.7% of the net sales proceeds (contract price minus closing fees). That is a lot more expensive than an Exchange. That is why it is always important to understand the goals of the client. What may seem more affordable may be more costly in the long run and what may seem more costly may be more affordable in the long run.

3. **Step-up in Basis.** This is of great value. When investors pass away, their heirs receive a step-up in basis. Basically, the cost basis moves up from the price

that the owner paid for the property to the value when the beneficiaries inherit it. If they sell it immediately, there will likely be little to no capital gains taxes.

Make sure that you don't get capital gains taxes mixed up with estate taxes. There may be some estate taxes due if the estate is large enough.

Value of Monetized Installment Sales (MIS)

1. **Flexibility.** For some, this will be the best value of the MIS strategy. Instead of having to replace a property with a like-kind property, one can take the proceeds and invest it how they desire. They have two options: business or investing in a financial vehicle of choice (mutual funds, CD's, stocks, annuities, etc).

   For example, let's say that an investor has multiple properties. They have leveraged debt on every property to increase their portfolio. One of their properties happens to be a highly appreciated property. They sell it and use the resources to pay off debts on other investment properties. That would be considered business use. Now, they have less debt.

   The investor could choose to buy a much lower priced property in another market and put the balance of the funds in a financial investment vehicle of choice.

   They can start any kind of business venture that they would like.

   They have options!!

2. **Exit Strategy.** In many cases, owners of investment properties no longer want to own those properties and deal with the challenges that come with tenants, laws, and so on. They'd like to "retire" from being a landlord. With a 1031 Exchange, you stay a landlord! With the MIS, the owner can sell their investment property and invest it into other financial vehicles that can create passive income from the growth. They might also choose to invest in other passive income business opportunities. They have options!

3. **No 45/180 requirements.** With a 1031 Exchange, the investor needs to identify up to 3 potential replacement properties within 45 days and close the identified property within 180 days. This works great if the market is great for buyers. But, what if the market is not doing well and there are not enough good properties to choose from? What if there are multiple offers on every property? There is always that big "what if". I've met too many people that basically said "had I known I was going to end up with this property, I would not have sold the last one." Tragedy.

   A common issue with these requirements is loss of negotiating power. When an investor is required to meet these deadlines, they may have to offer more on an identified property because they may be competing with other buyers to purchase it.

With the MIS strategy, there are no replacement time requirements. The investor can take the time needed to find the right property, the right fit, the right market, and without time pressures. If it takes 1, 2, 3, or more years, that is okay!

4. **Rescue a failing exchange.** Many 1031 Exchanges fail due to the above mentioned 45/180 day restrictions not being met, for many reasons. When that happens, Uncle Sam will be asking for that tax money the following April. Yes, another tragedy!

   With the MIS strategy, as long as the 1031 Exchange Accommodator will cooperate and release the funds to the MIS strategy, then the "failing" exchange can be rescued BEFORE it fails. It cannot be used to rescue an already failed exchange. Then, the taxes are deferred for decades as long as the investor follows the MIS investment guidelines. Tragedy avoided!!!

   Note: not all 1031 Exchange Accommodators cooperate with Capital Asset Dealers by releasing the funds to another strategy. National 1031 Exchanges Services does cooperate (**1031pros.net**)

5. **No Replacement Loan required.** In a 1031 Exchange, the investor is required to replace the debt on the previous property with an equal or greater debt on the newly purchased property. In some cases, this could present a problem if the investor finds out that their credit is not as good as they thought it was and now either don't qualify or have to pay higher interest rates than they thought.

   With the MIS strategy, the previous debt is not required to be replaced! One can simply pay off the debt and invest the balance of the resources as they desire.

6. **Increased Depreciation.** This section could be a whole article by itself so I'm going to keep it as simple as possible. In 1031 Exchanges, the depreciation schedule starts with the purchase of the first property. It ends 27.5 or 39 years after that purchase, depending on the type of property it is. That time clock continues to run, without resetting, with purchases of new properties through a 1031 exchange. The only increase in depreciation is any increase in value from the sale of one property to the value of another, with a new schedule on that increase. Any gains during ownership cannot be depreciated.

   With the MIS strategy, the investor sells their investment property and defers the capital gains and straight line depreciation taxes for decades. They stop the 1031 exchange chain upon the sale of that property. When they purchase a new property, they will start a whole new depreciation schedule (27.5 or 39 years) based on the full depreciable value of the newly acquired property. This can be a significant tax advantage!

7. **Increased Tax Savings on Future Sale.** In some cases, investors will buy properties of much greater value than the sale of the previous property. When they do this, they often do not realize that within a 1031 Exchange chain, the increase in value between the sales price of a previous property and the purchase price of the new property are considered capital gains. Should they choose to sell in the future, they will have to pay the capital gains taxes on the difference. That can be a big bill!

   Here is an example from one case we reviewed. The clients purchased a property for $250K and were selling for $900K. They had identified a property valued at $3M. In this case, the difference from the $900K sale to the $3M purchase would be considered gain in the future. That would be a $2.1M gain that would be taxable should they seek an exit strategy!

   With the MIS strategy, using this example, the client would defer the capital gains and straight line depreciation taxes for decades based on the $900K sales price. Then, the $3M purchase price would be considered the new cost basis. That reduces a future potential tax bill by over $700K based on current tax rates (in CA)!

   Going back to #6, this example would also provide a whole new depreciation schedule based on the depreciable portion of the $3M value.

Wrap Up:

Both strategies have their advantages and disadvantages. Both of them have their place in society. When exploring them, one should walk through the **#'s**, the **goals**, and the **personality** of the client. The strategy used should meet those criteria.

Disclosure: While this article provides general information about the two capital gains tax strategies, it does not constitute legal or tax advice. The best way to get guidance on your specific legal issue is to contact a lawyer.

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