The Right Way To Get Out Of A Real Estate Investment

It is relatively straightforward to get out of an investment in stocks, bonds, or mutual funds. You go onto your computer, make a few clicks, and voila, you're out. Depending on the type of account, there may be some tax consequences. In a tax-free account like a Roth, an HSA, or a 529, there pretty much aren't any. Likewise in a tax-deferred account like a 401K or traditional IRA, although there may be some planning as far as when and how to take the money out of the tax-deferred account eventually. You have to be a little smarter in a taxable account, where you can either hold an investment for at least a year to pay taxes at the lower long term capital gains rates, donate it to charity to avoid capital gain taxes completely (and maybe get a charitable contribution deduction if you itemize), or just die and pass it along to your heirs tax-free. Investments in individual properties are a little more complicated.

The 7 Ways to Get Out of a Real Estate Investment

#1 The Home You Live In

Getting out of the home you live in is more straightforward than an investment property. You can usually sell the place and move on to the next one. There are a few selling costs, including realtor commissions, repairs, and vacancies (the time you're paying the mortgage but not actually living there) which are not insignificant. I've found that 10% of the value of a property is a pretty good estimate of the selling costs, but it can be done for less if you're willing to sell it yourself or if you can avoid having it sit empty. There can be tax consequences as well. Until 1997, under Section 1034, you could exchange the equity in your home tax-free into another home of equal or greater value. That has since been repealed and replaced with Section 121, which basically allows you to exclude from income up to $250K ($500K married) in capital gains from the sale of your primary residence as long as you've lived there for 2 of the last 5 years. This essentially eliminates the tax consequences of selling a home for most home sales. Obviously, this provision of the tax code is highly discriminatory against those who live in expensive real estate markets like the Bay Area and Manhattan, as well as against those who stay in their homes for a long time.

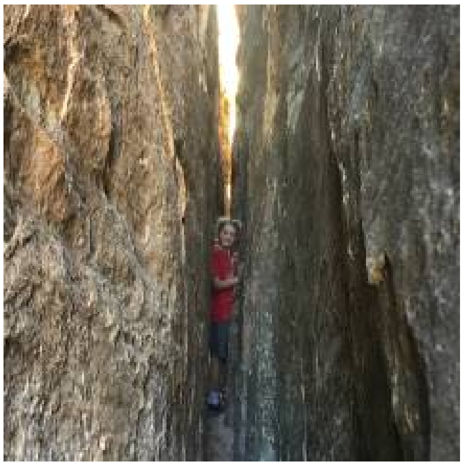
#2 The 1031 Exchange

Investment property is not entitled to this exclusion unfortunately. Section 1031, however, does allow you to exchange your investment property equity into another property while deferring the capital gains (and depreciation recapture) taxes due. This works fine until you wish to get out of real estate investing altogether. Then what are your options?

#3 Pay the Tax Bill

Option number one is to just pay the capital gains and depreciation recapture taxes due. If you bought the property for $100K, then depreciated it down over 14 years to $50K, and sold it for $200K, then you owe depreciation recapture taxes (25%) on $50K and long-term capital gains taxes (0-20% + 3.8% PPACA tax) on $100K. That could be as much as $12,500 + $23,800 = $36,300. That’s enough to make any investor stop and wonder if there’s a way to avoid that.

#4 Die



It’s much easier to get out of this tight spot than to get out of a real estate investment.

Option number two is to die. If you buy an investment property worth $100K and 50 years later you’re on your deathbed and the property is worth $1M, you’ve got two choices. You can sell it today and pay 25% of $100K (since it’s now fully depreciated) and 23.8% of $900K , or you can leave it to your heirs, who sell it the day after you die and owe no capital gains taxes, although your estate may possibly owe taxes if it is (in 2018) over $11.18M ($22.36M married). The property gets a step-up in basis at your death, so basically it’s as if they bought it at its value on the day of your death. Voila- an extra ~$240K for them.

#5 Live In It

What's that you say? You don't want to die or pay taxes. Luckily for you, there are a few more options. The best of the rest might very well be to live in the property. Once it becomes your principal residence, you are again eligible for that tax exclusion of up to $250K ($500K married) of depreciation recapture and capital gains taxes. You have to own the property for at least 5 years and live in it for at least 2 years to qualify under Section 121. Preferably, you live in it for at least 5 years to get the maximum exclusion. If you had only lived in it for 2 of the last 5 years, even though you owned it for 5, you only get 2/5 of the maximum exclusion.

The obvious issue here is that most investment property owners don't actually want to live in the type of property they invest in. Who wants to move from a 3000 square foot house into a 2 bedroom apartment for 5 years just to save $30K in taxes? There is another option. You can do a 1031 exchange from an investment property you don't want to live in into an investment property you would want to live in. You then rent it out for a while before moving your family in. How long do you have to rent it out for? The IRS doesn't specify. The only requirement is that you have the intent to rent it, and can prove it in an audit. I'd think a year of renting it out would be plenty, but it would probably be wise to consult with an attorney and/or accountant familiar with case law if you want to minimize this period.

#6 Work In It (Do You Really Want Out of Real Estate Investing?)

Another option is to exchange the investment property into a building you're now leasing for work. You get away from the hassles of managing tenants and save on rent, but don't owe any capital gains taxes on the exchange. Depending on why you want out of real estate investing, you might also be happy simply exchanging into a property requiring less management time, effort, and expense such as a “triple-net” commercial property.

#7 Give It Away

Another way to avoid those capital gain and depreciation recapture taxes is to [give the property away to charity](). The charity can then sell it tax-free and you may get an itemized deduction for the entire value of the property. Let’s say it is a fully-depreciated, paid-for property worth $200K. You get a write-off for $200K (possibly saving you up to $100K in taxes depending on your marginal tax rate), the charity gets $200K (minus transaction costs) and the IRS doesn’t get squat.

While you don’t have to pay taxes, you do lose the property. Paying $200K to save $50K isn’t exactly a smart business move. If you’re not feeling quite that charitable, you could do a charitable remainder trust. That means you give the property to the charity and they establish a trust for you for a certain number of years, such as 15-20, or until the death of you, you and your spouse, or all your grandchildren if you like. They sell the property and fund the trust with relatively conservative investments and use them to pay you interest for 15 years. Then whatever is left belongs to the charity. It's like buying an annuity (although the interest rate is significantly less, but by law at least 5%). You also don't get to deduct the full value of the donation, only the present value of the ultimate donation (the remainder), which must be at least 10% of the value at the time of the donation. Why would the charity do this? All charities won't, but those who do figure 10%+ in 15 or 20 years is better than nothing now. Many will put limitations on the trust as well, mostly because it isn't worth the hassle if they have to wait too long to get your money.

The Worst Way

Given the other options, just selling and paying the tax may not be the worst way to get out of the investment (especially if you have a loss on it.) But if you do this over and over again, it reflects a lack of planning on your part. If you're going to be a real estate investor, do it for the long-term, exchanging from one property to another as needed, and then you only have to deal with the costs and hassles of getting completely out of real estate once.

Have you needed to get out of a real estate investment? How did you choose to get out? Would you do anything differently? Comment below!