"MORTGAGE OVER BASIS" PROBLEMS? NOT ANY MORE...

If you (or your clients) own real estate or other capital assets with a mortgage over basis situation, or you wish to defer the capital gains when you sell the assets, there is a strategy approved by the Internal Revenue Code (IRC) that allows you to defer the gain for up to 20 years.[1]

OVERVIEW:

Many investors own real estate or other capital assets in partnerships and LLCs with negative capital accounts due to "mortgage over basis," in part because they used accelerated depreciation to write off the asset or borrowed against the asset(s) to withdraw "tax-free" cash. "Phantom income" is generated when the asset is sold and, often, the taxpayer will not have enough cash from the sale to pay the income taxes on the total gain.

EXAMPLE:

A partnership owns an apartment building and a 40% Partner's allocable share of the building is as follows:

Adjusted Basis:	$2,500,000
Mortgage:	7,500,000
Gross Value:	10,500,000
Equity:	3,000,000

The partnership wishes to sell the building and use the cash to invest in assets other than real estate, with $3,000,000 in cash (net) allocated to the Partner.

ISSUE:

The total gain that would be realized by the Partner upon a sale of the building for its gross value would be $8,000,000 (Gross Value minus Adjusted Basis). The minimum gain (i.e. the "*phantom gain*," as measured by the liability on the asset minus the adjusted basis) would be $5,000,000.

If the Partner sells the partnership interest for its value, receiving $3,000,000 in cash, the entire $8,000,000.00 gain is reported immediately. The Partner's amount realized includes the mortgage encumbering the real estate, even though the Partner is not personally liable on the mortgage. The "phantom gain" is therefore $5,000,000.

If the $8,000,000 capital gain is taxable at a combined effective tax rate of approximately 30% (taking into account the 25% rate for Section 1250 depreciation, the 15% rate for the remainder of the capital gain, as well as the 9.3% state income tax rate), the total income taxes on the $8,000,000 gain would be $2,400,000, leaving the Partner with only $600,000 after the payment of all income taxes.

[1] This strategy only applies if the investor is willing to hold the asset for two years after selling the partnership interest (IRC § 453(e)).

SOLUTION:

If the Partner does not have other assets to contribute to the partnership to increase basis, a specific life insurance strategy may be the solution.

Furthermore, if the Partner is willing to wait two years for the market to rebound before selling the real estate (or other capital assets), there is an IRC-approved strategy that allows him/her to sell the assets for cash and **DEFER THE REPORTING OF THE CAPITAL GAIN FOR UP TO 20 YEARS**.

If you or your client is facing this situation and would like to further discuss the IRC-approved strategy to resolve this, please contact us at (702) 341-6009 x1 or e-mail jeff@jmvlaw.com.

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