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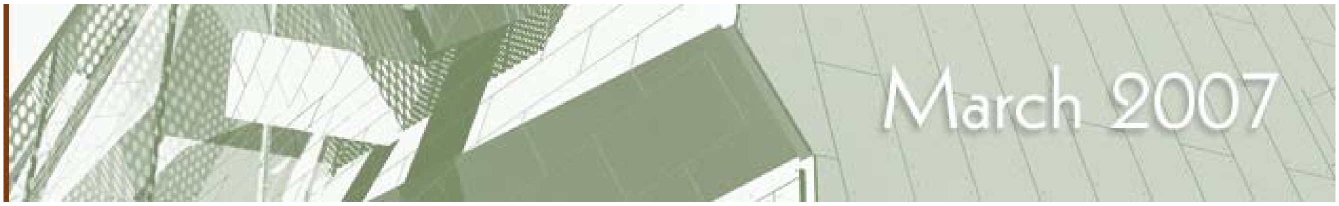




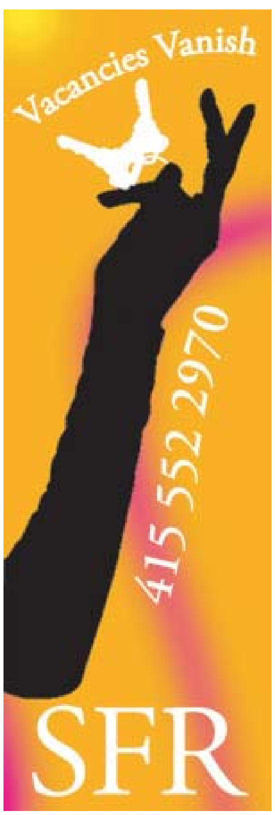


FEATURE

## *Structured Sales: A New Take on an Old Tax Strategy*

by Larry Weiss

As a CPA and financial advisor, I work with many clients who have an enviable real-estate problem. They bought their rental properties 20 to 30 years ago. They worked hard to maintain their properties and have good relationships with their tenants. Many of these clients bought their properties for approximately $150,000. Now they find their properties to be worth over $1,150,000 each.

As they approach retirement they want to benefit from the equity they have built in their investment real estate, and they are tired of the nuisances that are associated with being a multiunit property owner. One client commented, “After all my expenses, sometimes I make only $10,000, which really represents less than a 1% return on the $1,150,000 property. In addition, I am tired of the late-night calls, trash around the building and broken toilets.” So, they decide to sell. But many are wary of the considerable capital gains taxes on such a sale.

Here is an example: Assume a client bought a property for $150,000 more than 20 years ago. Today the property is worth $1,150,000. The taxpayer has deducted $100,000 in past depreciation expenses. The client decides to sell the property and wants to understand the tax consequences of the sale. These are the calculations I would show the client:

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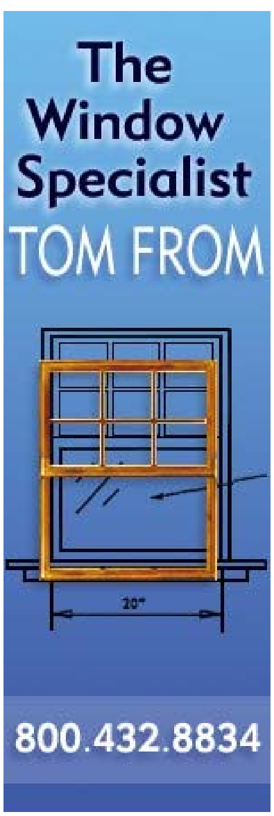
|---|---|---|
| **FEDERAL TAXES** | | |
| **Depreciation** | | |
| Recapture | 25% | $25,000 |
| Capital Gain Taxes | 15% | 150,000 |
| Total Federal Taxes | | 175,000 |
| **CALIFORNIA TAXES** | | |
| Income Taxes | 9.3% | 102,300 |
| **Total Estimated Taxes** | | $277,300 |

The tax rate from the sale of this property is approaching 28%. (This is just an example. In reality, other tax rates could apply or tax deductions could be affected by alternative-minimum tax considerations.)

So, you may ask, “What is the best way for me to sell my property without being clobbered by taxation?” The answer depends on the individual client’s needs and the


whole financial picture. There are three often-utilized tax-deferral options when selling highly appreciated real estate. A 1031 Exchange allows you to defer the taxes from the sale of an investment property or properties as long as the property is replaced by one or more purchases of "like kind" investment properties. A Charitable Remainder Trust allows you to sell your property without capital gains tax. This method provides you annual income for your lifetime, and provides you a charitable deduction on your income tax return. A CRT removes this asset from estate taxation exposure. Finally, an installment sale allows you to receive payments for your property over multiple years. Since you receive your sale proceeds over a number of years, capital gains taxes are paid over a number of years.

### A Closer Look at Installment Sales

Many of my clients prefer the idea of receiving their payments over a period of years and paying their capital gains taxes over the same number of years. For many clients approaching retirement, an additional source of predictable income sounds ideal.

In an installment sale, the seller negotiates the sale price (including the frequency and amount of payments) with the buyer. For example, a property is sold for $1 million. The buyer agrees to pay the seller $100,000 now, and $100,000 a year for the next nine years. The seller provides financing for the buyer. The buyer now owns the property, with the seller receiving a partial payment and a note secured by the property. Each year, the seller of the property receives $100,000. The payment will be considered in part a return of basis (tax free), in part capital gain (subject to capital gains taxes) and in part interest payment (ordinary income tax).

For some clients, the installment sale perfectly suits their tax and income needs; but there are also many clients who are uncomfortable being the bank for someone else and desire more security. These clients want to feel confident that they will receive their payments as agreed upon. They want to simplify life and be able to enjoy other pursuits.

Such clients often ask these questions: "How can I be sure I will receive my payments? What if the buyer stops making payments? Do I have to foreclose on the property? How can I protect myself?"

For these sellers, the "structured sale" can be the right solution. A structured sale can provide the security desired, while still offering a considerable tax advantage.

### Structured Sales

Over the past several decades, many civil court cases have used an annuity product to fund damages. You often read about horrific accidents in which people were badly injured. At a civil trial, a jury decides that substantial damages are owed to the injured parties. In most cases, these damages require lifetime payments to the injured party. The payments from these lawsuits are often funded by large insurance companies and are called structured-settlement annuities. They provide an annual payment for a period of years or a lifetime. These structured settlements provide the economic assurance that the injured party will receive income in a timely manner.

These large insurance institutions looked at the highly appreciated real-estate market and determined their structured-settlement product could be utilized in installment sales—thus the birth of structured sales.

In a structured sale, the seller negotiates the terms of the sale of a property with the buyer. For example, with a $1 million sales price, the seller will receive $100,000 now and $100,000 a year for the next nine years. The buyer purchases the property and pays cash to an assignment company. The assignment company


buys an annuity from the financial institution. The buyer's obligation is transferred to the insurance company issuing the annuity. The seller receives the annuity payments over a period of years. The capital gain is recognized and the associated capital gain taxes are paid over those years.

Most of the companies involved are large, well-known life insurance companies. Thus, clients can sleep well at night and feel assured that they will receive each and every payment from the sale of their properties. Another benefit is that, unlike an installment sale, in a structured sale, property financing is not provided by the seller. The buyer must arrange for property financing. The plus for buyers is the negotiation of a better price for the property through a willingness to accommodate the seller's desire to defer and recognize the capital gain tax over a period of years. Under the right circumstances, a structured sale can benefit both the buyer and the seller.

Using structured sales, my clients are now able to sell their highly appreciated property without having to pay the tax immediately. They are able to enjoy receiving payments over a number of years and paying capital gain taxes over the same timeframe. Best of all, they are relieved of the worry about the property buyer's ability to pay because their payments are guaranteed by a large financial institution.

Many professionals believe the structured-sales concept can be an excellent real-estate sales planning tool. The large insurance companies have designed these products to best meet the needs of the buyer and seller. Installment sales have existed for many years and have specific rules outlined under Section 453 of the Internal Revenue Code. As with any new strategy, the IRS has not yet provided a ruling on structured sales annuities, nor have they commented on them.

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