Strategies & Trends

Structured Sales of Appreciated Property: A Space Age Use for Fixed Immediate Annuities

by David M. Cordell, Ph.D., CFA, CFP®, CLU

Financial planners with taxable clients who are considering the sale of appreciated real estate or a business may want to consider and present the possibility of allocating at least a portion of the sale to a structured sale.

It's amazing how seemingly intractable problems can sometimes be solved by rummaging around the spare-parts bin. If you ever saw the movie *Apollo 13* (or if you're old enough to remember the actual event), you remember the problem that perplexed NASA engineers during that ill-fated mission to the moon. From over 200,000 miles away, they somehow had to figure out how to assemble a device to reduce carbon dioxide in the capsule using only ordinary parts that were already in the capsule. Demonstrating unbelievable ingenuity, they succeeded and the rest, as they say, is history.

I was reminded of this incident in the course of a recent conversation with Henry L. Strong, president of JMW Settlements Inc., who told me about a clever way to use an old financial instrument, the mundane (pun intended) fixed immediate annuity. It involves a transaction format called a structured sale, and it offers sellers an alternative method of disposing of highly appreciated property in a way that overcomes many of the limitations of their other options-cash sales, installment sales, and, for real estate, Section 1031 exchanges.

Client, We Have a Problem

To understand how attractive this new option may be, consider the limitations of the traditional alternatives. Cash sales are full and final, but they also trigger immediate recognition of capital gains and create a sudden "liquidity event" that may be difficult for some sellers to handle. Traditional installment sales offer tax deferral with a series of periodic payments, but they expose sellers to the uncertainty of the buyer's creditworthiness. Given the potential cash-flow and legal problems associated with default and repossession, some sellers shy away from this approach.

Section 1031 exchanges offer unlimited tax deferral and preserve the step-up in basis for heirs, but as the real estate market becomes increasingly tenuous, some sellers may have difficulty finding suitable—and reasonably priced—replacement properties within the time periods allotted to complete the transaction. Section 1031 exchanges also have the limitation of leaving the client invested in real estate, which may not be in the client's best interests.

Consider the case of a client who wants to sell a business or shift assets out of real estate and who wants to defer the tax without assuming credit risk associated with a buyer's promise to pay. Until now, achieving that goal was beyond the realm of possibility. By borrowing a simple device from the personal injury settlement market, sellers may now be able to achieve this very result.

Making Use of a Financial Spare Part

One key to the successful development of the structured settlement market has been satisfying the settling defendant's desire to eliminate his or her long-term obligation to pay. This outcome is achieved by obtaining the defendant's acceptance of a series of future payments, then immediately transferring that obligation to another entity via a "third-party assignment." (Under contract law, this substitution of one party for another in the context of a contract is known as "novation." Like the fixed immediate annuity, it is ordinary, noncontroversial, and has existed in the marketplace for a long time.)

Borrowing this approach for a client's disposition of an appreciated asset, the advisor can create a structured sale-a sort of new and improved installment sale. A typical deal might look like this: The buyer and seller separately assess the value of a property and negotiate a sales agreement that calls for a specified amount of cash to be paid at settlement plus a schedule of periodic payments crafted to meet the seller's timing needs. The buyer executes a "third-party assignment" with a third-party obligor who promises to assume liability for all future payments owed by the buyer to the seller. To defer income recognition, a third party is needed in the equation to insulate the seller from a potential determination of taxable receipt of the funds (constructive receipt or economic benefit).

The new obligor further agrees to fund their obligation by buying an annuity contract from a highly rated life insurance company that will make the periodic payments directly to the seller. Finally, the life insurer issuing the annuity contract agrees to guarantee the performance of the third-party obligor, thus fully upgrading the credit quality of the transaction. Credit risk has been a major weakness that has hindered use of installment sales in the past. Separating the parties this way can add unique value in divorce property settlements, for example.

Lest anyone worry over the quality of the life insurance companies involved, remember that this transaction design evolved in the ultra-conservative structured settlement market where future payments must be secured for injured persons, widows, and orphans. The current market leader in the structured sale market is none other than Allstate Life Insurance Company, as conservative an organization as they come.

As promising as this structured sale is, there are limitations to its use, and it won't be the best alternative for all sellers for a variety of reasons.

1. As with all tax strategies, there is always the risk that favorable tax treatment may be disallowed in the future.
2. The payments are illiquid. Once the structure is established, there is no way for the seller to access the funds. Otherwise, there can be no tax deferral.
3. The tax deferral strategy itself could backfire if the seller's personal tax rate is higher in the future than the rate in effect at the time of sale.
4. Given the conservative nature of the funding vehicle, returns may be less than sellers have grown accustomed to.

If All Systems Are Go

Still, there is considerable interest in this concept for some perfectly logical reasons. Given the strong economy of the last ten years, especially the remarkable increase in real estate values in many geographical markets, more Americans than ever hold highly appreciated property. At the same time, the shift away from classic defined-benefit plans to 401(k) and other defined-contribution plans has produced a great number of middle-aged and older people who are concerned about the stability of their retirement incomes. The ability to convert an illiquid, risky asset with an uncertain future income stream and value into a predictable, low-risk source of income for either a period-certain or for life is a concept that will appeal to many.

Financial planners with taxable clients who are considering the sale of appreciated real estate or a business may want to consider and present the possibility of allocating at least a portion of the sale as a structured sale. Carefully considered, and in the right circumstances, a structured sale can provide an optimal transaction arrangement that addresses the important issues of risk management, diversification, and income. And it can be created right here on earth.

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