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Structured Installment Sales:

An Alternative to 1031 Exchanges

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One of the biggest impediments to the sale of appreciated real estate at a market high is the concern over capital gains taxes. Depending on the size and nature of the transaction, there could potentially be significant tax implications. An owner of real estate investment property could use the §1031 like-kind exchange provisions to defer gain recognition and maintain the potential step-up in basis upon the passing of the property to heirs. However, for some, it may not be practical to exchange real property for other real estate as is required by §1031.

Paramount to investors may be reducing their holdings in real estate and diversifying, but perhaps the time limitations imposed by §1031 — that require identification of replacement property within 45 days and subsequent closing within 180 days — are too restrictive. Exchanging high-value real estate often leads to an acquisition of replacement real estate that is also at the top of the market.

As an alternative to a §1031 exchange, an investor can achieve gain deferral by entering into an installment sale of real property under §453. Instead of the seller receiving a full cash payment from the sale, the buyer and seller agree to installment payments for a stated number of years and at a certain interest rate as a condition of the sale. For the seller, capital gains taxes are paid as the installment payments are received, rather than up front in the year of sale. In determining the payment terms, the seller may have flexibility in establishing the annual principal payments and may be able to manage the effective capital gains rate and tax owed through proper tax planning. The seller will generally have a first or second mortgage position when providing seller financing to the buyer, providing security in the event of the buyer's default on the mortgage note.

It is important to mention that installment sales do not come without risk for the seller. While retaining the rights to the future payments and reclaiming the title should the buyer default, the seller may reacquire the property at a diminished value due to market conditions or the buyer's mismanagement of the property and incur legal costs related to foreclosure or forbearance.

Rather than arranging for seller financing with a buyer, the seller may want to consider a structured installment sale which also utilizes a periodic payment plan that enables the spread of capital gain taxes coupled with dependable installment payments over time. Structured installment sales involve a third-party obligor, preferably of high credit quality, to facilitate the installment sale and administer the note payment and investment of the sale proceeds. With a structured installment sale, the buyer does not make periodic payments to the seller. Rather, the buyer assigns the payments to the third-party obligor company (Assignee), which agrees to take on the obligation and make the note payments. The Assignee will invest the proceeds collected from the buyer to provide for a return sufficient to meet the note obligation owed to the seller. With the structured installment sale, the seller is not required to receive all funds through periodic payments. The seller may decide to receive only a portion of the payments in the years after the sale and receive the balance of the note in a lump sum. The interest payments received by the seller on note payments will be taxed as ordinary income.

The structured installment sale must be agreed upon before the sale of the property takes place and is documented as a contractual provision in the purchase and sale agreement. The money from the sale must be managed in such a way that the seller is not treated as having constructively received the payment prior to the time it is actually made. If a structured installment sale is not considered until the time the property is about to close, it is likely too late. The IRS would look at the transaction as a tax deferral tool added to an existing transaction that has essentially been accomplished and initiated for tax avoidance.

For the buyer, there is little difference from a traditional real estate purchase. The buyer has paid the contract price in full and gets the full title at time of closing.

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