281 Tresser Boulevard, Stamford, CT 06901-3226 ■ 203-973-5900

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Robert W. Wood, Esq., Wood & Porter

SELLING REAL ESTATE? SELLING YOUR BUSINESS?

Defer Tax and Be Safer with A Structured Sale

The good news is that you've agreed to sell investment property or your closely held company at a large gain. Now you will have more funds for investment or to support your retirement, whether that will come right away or decades in the future.

The bad news? A large gain means a large amount of tax, payable on your next tax return.

One proven solution is to enter into an installment sale agreement with the purchaser of your property or business, allowing him/her to defer the payments over more than one year. You'll defer your tax bill, too.

Benefit: Paying tax later is better than paying it sooner. You also may keep from creeping into a higher tax bracket if you take smaller amounts over a period of years.

Example: You sell your property, or company, in an installment sale scheduled over seven years. Each year you receive one-seventh of the total amount, calculated to reflect interest on the unpaid installments.

If each annual payment is $250,000, you'll owe tax on the gain portion of $250,000 per year, not on the gain portion of the entire selling price in year one.

But installment sales may encounter problems, as explained below. Such problems can be addressed with a *structured sale*, which creates a secure flow of tax-deferred income.

Real solution: For real estate transactions, a structured sale may be preferable to a like-kind exchange, where property is swapped on a tax-deferred basis, because the seller can pocket cash and discard management responsibilities.

Structured sales also do not have the time limits of property exchanges, and they offer a way to diversify investments away from real estate.

INSTALLMENT SALE IRRITANTS

By its very nature, an installment sale calls for the buyer to take possession of your property now and pay you later. *Danger:* Such payments may not occur if the buyer subsequently runs into financial problems.

When an installment sale falls through, the seller generally has some recourse, such as reclaiming the original property.

Trap: Some sellers have found that they are inadequately secured in case of a default. They may not be able to collect what they are owed.

Insult to injury: Pursuing a buyer after an installment sale collapses is likely to be frustrating, expensive, and time consuming. Even after a "success," you may merely be reclaiming a building or a company that has been mismanaged, while you are older and perhaps ready to retire.

Tax treatment: If you do wind up with some or all of the cash to which you are entitled after the buyer defaults, you'll owe tax right away, so your goal of tax deferral will be lost.

Securing the deal: Some forms of security traditionally have been used in installment sales, such as letters of credit, deeds of trust, and pledges of stock.

Unfortunately, in many cases, these arrangements provide poor collateral. Even if the seller manages to collect, taxes are accelerated.

STRUCTURING INSTALLMENT SALES

Recently, structured sales have gained popularity. In essence, the deferred payments to you are provided by an annuity that is backed by an insurance company. This is as close to a guarantee of future payments as you can get.

How they work: A seller enters into an agreement with a buyer, who consents to purchase the required annuity.

Example: Jean Williams agrees to sell appreciated rental property to Mark Davis, who will pay her $250,000 a year for seven years. Mark's obligation and note is to Jean, the seller.

Next, Mark assigns his obligation and note to an "assignment company." This affiliate of a life insurance company will assume the liability of making the installment payments.

Paying off: Mark pays a lump sum to the assignment company. This sum is the present value of the payment stream due under the installment sale agreement.

This transaction is between the buyer and the assignment company. Jean, the original seller, isn't a party to the assignment of the obligation.

After making its deal with Mark, the assignment company typically will use the funds to buy an annuity from a highly rated insurance company. The insurer will guarantee the required installment payments if the assignment company defaults.

All of the terms of the installment agreement between Jean and Mark continue to apply, including any pledges of collateral.

Tax Hotline interviewed Robert W. Wood, Esq., partner at the tax law firm Wood & Porter, 333 Sacramento St., San Francisco 94111 (*www.woodporter.com*). Formerly the vice chair, taxation section, for the state bar of California, he is author of *Taxation of Damage Awards and Settlement Payments* (Tax Institute, *www.damageawards.org*).

SETTLING UP

The arrangement described above derives from the structured settlement industry, which has grown in recent years.

Structured settlements have become common in the aftermath of personal injury lawsuits, workers' compensation cases, and so on. One party, entitled to a stream of cash flow, takes a lump-sum payment up front from investors. Brokers bring these recipients together with the investors, who'll collect the guaranteed payouts while insurers provide the annuity contracts.

The same brokers and insurers now are moving into structured *sales*.

Suggested: ATG Trust Co. (*www.atgtrust.com*), considered to be one of the founders of the structured sale, may be able to help buyers find an assignment company and annuity quotes.

In addition, an Internet search for "structured settlements" plus "assignment company" will reveal many assignment companies for the buyer to evaluate.

TAXING MATTERS

The key to this transaction is that the seller of the original property (such as real estate or a private company) is not involved with the annuity arrangement. The seller has entered into a deal with the buyer, and what the buyer does is another matter.

The seller isn't a party to the assignment of the obligation, as mentioned, so the seller shouldn't be involved in the negotiations. The seller can indicate that this is the type of transaction that will make the seller feel comfortable and then suggest the buyer work with professional advisers to develop a satisfactory guarantee for the seller, via a structured sale.

Essential: The seller will receive payments over a period of years, and pay tax as payments are received. As long as the seller is not a party to arranging the annuity, the tax need not be accelerated.

Therefore, a structured sale can provide the seller with both the security of knowing that the agreed-upon payments will continue as well as the same tax deferral that an installment sale can offer. ■ ■