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The Structured Installment Sale as a Real Estate Tax Strategy

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THE STRUCTURED INSTALLMENT SALE AS A TAX MITIGATION STRATEGY

If there is one maxim known to all real estate investors, it is, "location, location, location. . . ." Not far behind, however, is the fact that real estate is cyclical.[1] There are many competing economic theories that explain the cyclical nature of real estate, but nobody who understands buying and selling property can argue with the fact that real estate cycles up and down over time as do the concomitant capitalization rates attendant to investment property expand and compress.[2]

This cyclical element of real estate calls to mind another real estate maxim that competes with "location, location, location. . ." for the top spot — "buy low and sell high." Seems simple enough, right? Not so fast. What happens when real life intersects with the theoretical? More specifically, what if it is necessary, for personal or other reasons, to sell real estate in a down market or to purchase real estate at the top of the market? Real estate investors are human beings. They experience marriages, divorces, college tuition payments, the weddings of children, the births of grandchildren, windfalls, cash shortages, credit issues, and innumerable other opportunities and challenges. Thus, it is not always possible, or, in some cases, even desirable, to buy low or to sell high.

Real estate enjoys a special place with respect to tax law.[3] There are tools afforded to real estate investors throughout the Code[4] that are unlike investment in any other asset class. There are provisions that relate to depreciation, rules about the payment of capital gains taxes, the concept of the step-up in basis at death, and, of course, the like-kind exchange rules established pursuant to §1031.

For the moment, let's set aside §1031. We will return to this subject later. One of the most powerful drivers that prevents the disposition of real estate at the best possible time is the specter of capital gains taxes.[5] As an attorney and a financial services professional, it is not an understatement to relate that our seller clients get almost physically ill when we discuss their potential capital gains tax liability upon the sale of their real estate assets. Thus, it is our job (as a lawyer and a financial planner, respectively) to present options to these potential sellers.

In a situation where §1031 is not an option, we often look to Qualified Opportunity Zones (QOZs)[6] and

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[1] The Real Estate Cycle, InvestmentPropertiesInfo.com.

[2] Ryan Frankel, What is Caprate Compression? Millionacres (June 11, 2021).

[3] Sanjeev Bhatia, M.D., and David B. Mandell, J.D., M.B.A., Real estate, permanent life insurance provide tax benefits, HemOncToday (Apr. 14, 2021).

[4] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[5] Jean Folger, *Here's How Capital Gains Taxes on Investment Properties Work*, Millionacres (Aug. 11, 2021).

[6] IRS, Opportunity Zones Frequently Asked Questions.

Qualified Opportunity Funds (QOFs)[7] and to other tools in an effort to mitigate capital gains liability, but we often continue to experience some degree of ongoing frustration on the part of sellers because of the limitations of these other tools. We knew that there were others out there promoting various questionable tax strategies that either were/are not sound from a tax perspective and/or the process of utilizing many of the strategies that do pass muster were/are so convoluted and disorganized that they did not and do not engender a great deal of confidence on our part as legal and financial advisors or on the part of the clients, themselves. ''There has to be a better way to do this!'' one of us would exclaim at some point in the process.

So, we sat down with the tax partners at our firm, and we explained that we wanted to create a tax deferral strategy that was simple, elegant, legal, and easily explainable to clients. We decided to use §453 (installment sales) as a foundation to build upon.[8] We had seen various other uses of the installment sale provision over the preceding 10 or 15 years, but all had problems, and all had generated bad outcomes and bad press. We needed to build something that was ours, that was not shrouded in secrecy, that was harmonious with the Code, that was a well-designed new tool for tax mitigation upon the sale of ANY highly appreciated asset, real estate included. The result – the Structured Installment Sale (or ''SIS'').

THE LEGAL UNDERPINNINGS OF THE STRUCTURED INSTALLMENT SALE

Rather than stringing together a bunch of unrelated Code provisions in a ham-handed attempt to cobble together some newfangled strategy, we relied on one provision and one provision only – §453. While §453 is not nearly as rigid, complex, and uncompromising as §1031, there are still a host of requirements that must be satisfied so that the IRS will honor the transaction.

The most obvious of these requirements is that there cannot be ''constructive receipt'' of the sale proceeds by the seller. Any monies paid by a buyer must go somewhere else other than to the seller. If the sale proceeds wind up in the hands of the seller or somewhere that is under the control of the seller, it is exactly as if the seller sold the asset for cash consideration, and this triggers the imposition of capital gains taxes immediately.[9]

A related concept (no pun intended) is the idea of a ''related-party transfer.'' As noted in the paragraph above, the sale proceeds cannot go to a person who is a family member, friend, attorney, financial advisor, accountant, or ''*Any Other Person''* with whom the seller has a prior existing relationship OR to an entity of any type controlled by such a person. Instead, the proceeds of the sale must go to an entity that is completely remote to the seller. Obviously, this creates a potential trust issue for the seller, but we create special purpose vehicles (SPVs) that are entities with multiple members who are professionals, who do this type of work for a living, and are beyond reproach. We also incorporate multiple checks and balances such that it would be physically impossible for a Managing Member of an entity that has been created to manage the proceeds of a sale to ''go rogue'' in any way whatsoever.

While we are on the topic of the SPV, it is worth mentioning another tax concept, the ''business purpose rule'' (BPR).[10] In essence, the BPR states that any entity that is created as a repository for the sale proceeds, in this case, the SPV, must have a specific business purpose other than merely facilitating tax deferral. So, these SPVs that are created to receive the sale proceeds must invest the proceeds, using a financial advisor, with the bona fide intention of earning a return above and beyond the interest that is promised by legal agreement (the ''Note'') to the seller and the expenses related thereto (the ''Overhead''). We will discuss these mechanics in the next section.

There are several other features of the SIS that are designed to be fully compliant with both the letter and spirit of the Code, but these are the most significant elements. In summary, we have created a structure that has, relative to other structures, a sophisticated yet 100% legal architecture. We did this after years of surveying competing strategies that are flawed in either their design, their implementation, or both.

THE MECHANICS OF A STRUCTURED INSTALLMENT SALE

We have already referred to elements of the SIS that include the seller, the buyer, the SPV, the Note, and the Overhead. Here we explain how these elements relate to each other to form this elegant and fully Code compliant structure. We do this by going through the timeline of a hypothetical real estate transaction where the use of §1031 is not an option. Assume for this example that there is a single individual who is selling multifamily real estate (an apartment building) that she has held for a very long time. Assume a cost basis of $500,000 and no improve-

[7] IRS, Invest in a Qualified Opportunity Fund.

[8] Notable Tax Implications of Installment Sales, PWC (2016).

[9] Constructive receipt definition, Accounting Tools (Aug. 1, 2021).

[10] Business-Purpose Doctrine Law and Legal Definition, USLegal.com.

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ments. Also assume that depreciation has all been used. Finally, assume that a buyer has made a firm offer in the amount of $5.5 million for the apartment building, but that there are still some remaining contingencies relative to the transaction ultimately closing.

At the beginning of the SIS journey is the seller. We have already learned a bit about our fictitious seller. Now assume that the seller has reached out to her financial advisor and that he has directed the seller to a maker of an SIS (or that the seller came to the firm directly to structure her transaction). Do you recall in the above paragraph where we assumed some contingencies with respect to this proposed transaction? That was highly intentional. While it is never too early to engage my team to structure an SIS, it can be too late. If the transaction has no contingencies left and is about to close, it is generally too late to structure an SIS because of another tax law rule known as the ''sham transaction doctrine'' or by its unfortunate acronym, the ''STD.'' The STD basically says that one cannot simply inject a tax deferral tool into an existing transaction that has essentially been accomplished but not yet closed as to do so would be nothing more than a ''sham'' in the eyes of the IRS.

So, let's assume that the seller engages us to structure an SIS transaction when there is this $5.5 million offer on the table but contingencies remaining. The first thing that we do is to craft language that will be inserted into the purchase and sale (P&S) agreement that references the use of an SIS and redirects the flow of the transaction in ways that we will discuss shortly. At the same time, we create and structure the SPV with its multiple members and a manager, as we typically use a limited liability company as the SPV. The SPV will have its own federal tax identification number and will be domiciled in a state that makes sense considering the totality of the circumstances. Finally, we structure the Note. Think of the Note as a contract between the Seller and the SPV. The Note will contain such features as:

- The interest rate that the SPV will pay to the seller and the schedule for such payments (monthly, quarterly, semi-annually, annually, etc.);
- It will also specify any deferral of payments for a period of time to allow the income to accrue in the SPV's accounts;
- A schedule for the return of principal (and/or the proposed scheduling of any balloon payment that might be incorporated into the agreement);
- A description of the rights and responsibilities of the seller and the SPV; and
- A description of the Overhead.

At the time of the closing, the title of the asset is conveyed first to the SPV and then subsequently to the buyer. The buyer wires the $5.5 million purchase price to the SPV's account and the seller (then known as the ''note holder'') is formally a party to the Note. In this way, the seller/note holder/taxpayer has not received anything of value other than the Note. She has merely a promise made by the SPV – a promise to repay the principal (the gross purchase price, net of taxes) on some later date or, more often, a series of dates, and the right to interest payments based on a stated interest rate that is memorialized in the Note. Thus, there has been no taxable event. To recap, the buyer receives title to the asset and drops out of the equation. The seller has the Note, and the SPV has the sale proceeds. The key here is that no capital gains taxes are paid, and none are owed at this time. Thus, the SPV has 100% of the sale proceeds and not just the 60% that is left over after the payment of federal and state (averaging here) capital gains taxes. The SPV is charged with investing the money in stocks, bonds, mutual funds, insurance products, alternatives, and any other prudent investment, and is obligated to pay the note holder interest and principal in accordance with the Note.

The interest payments made by the SPV to the Note holder will be taxed as ordinary income. Finally, although there is no step-up in basis in a §453 transaction, at the time of the Note holder's death as all she owns is the Note, the principal will likely fall outside her taxable estate. So, there is a clear estate planning element to this strategy as well. Finally, it is worth noting that, like any other asset, the ability to maintain the Note with the SPV and to continue to receive income and principal in accordance with the Note, can be passed down to a surviving spouse or any other heir or heirs as part of an estate plan.

A quick word on Overhead. Typically, the SPV will retain a financial advisor to make investments on behalf of the SPV. The average cost of maintaining such a relationship is 100 basis points (or 1% of the value of the portfolio). The SPV must also be paid and the cost for maintaining the SPV is typically 50 basis points or 0.5% of the value of the portfolio. The idea is for the SPV to make prudent investments that enable it to cover costs and to pay the rate of return that is memorialized in the Note to the taxpayer. Recall that the SPV has a business purpose in that it must also strive to earn an additional return above and beyond covering the Overhead and paying interest to the taxpayer. Thus, in a situation where the interest rate is set at 5% annually in the Note, the SPV should be targeting an overall return of something north of 6.5% with 5% going to the note holder/ taxpayer (our original seller), 1% going to pay the fee of the financial advisor, 0.5% being paid to itself as compensation and

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something above and beyond that to turn a profit over time, thereby satisfying the BPR.

THE STRUCTURED INSTALLMENT SALE AND REAL ESTATE

This article began by describing some of the unique elements of real estate investment. Now that we have explained how the SIS works, it is (hopefully) easy to understand the power and the benefits of using the strategy with respect to real estate investing. Since 2018, §1031 can only be used to effectuate the like-kind exchange of real estate.[11] Therefore, when a client or a perspective client who is selling highly appreciated real estate asks us for advice regarding taxation, we typically suggest that they do either a traditional or passive (in the form of a Delaware Statutory Trust) like-kind exchange pursuant to §1031 because of the power of the step-up in basis. Whereas, if the client or prospect is selling any other type of highly appreciated asset, including collectibles, art, personal property, or a going-concern business, we introduce them to the SIS concept.

However, sometimes even real estate investors do not want to exchange investment property for more investment property as is required by §1031. This may be because there is an overconcentration in real estate relative to other asset classes, but it is often because of the strict time limitations of §1031. Because the would-be exchanger has only 45 days to identify in writing and 180 days to close on the replacement property, that real estate sale at the top of the market often means a forced purchase of replacement real estate also at the top of the market. Without digressing into a discussion of cap rates, oftentimes the math does not add up and the §1031 exchange no longer makes any sense, the step-up in basis notwithstanding.

The SIS gives real estate investors the power to time their future investments in real estate according to their schedule and not the government's timeline. In this way, sellers are able to sell at the top of the market and buy during a trough, something that is challenging at best in a §1031 exchange situation. At the same time, the seller can pick the best time for the payment of her capital gains tax obligations as the structure is nimble and flexible. Often for seasoned real estate investors, the ability to time both the purchase of new real estate and the payment of taxes is a stronger value proposition than complying with the onerous requirements of §1031. Moreover, with proper planning and structuring, the use of the SIS could allow the taxpayer to reset her basis to the new purchase price and depreciate accordingly.

THE STRUCTURED INSTALLMENT SALE AS A §1031 RESCUE MECHANISM

Anyone with any knowledge of the realities of §1031 knows that there is a high failure rate (typically, either a failure to timely identify replacement property or to close on same) with respect to like-kind exchanges. The default qualified intermediary (''QI'' or Accommodator) agreement states that, if the exchange fails, the QI must direct the sale proceeds back to the seller, thereby creating a taxable event. However, in all states except for California, it is permissible to insert language into the QI contract wherein, should the exchange fail for any reason, the sale proceeds should immediately be wired to an SPV rather than the seller. This avoids a constructive receipt issue and allows the SIS to function as a rescue mechanism for a failed exchange under §1031. The use of such language where allowable is highly recommended to avoid a capital gains taxation disaster.

CONCLUSION

The Structured Installment Sale is a powerful capital gains tax mitigation tool, one with tremendous versatility, flexibility, and customizability. It is often referred to as a ''bespoke'' solution to the tax liability that comes with the sale of highly appreciated assets. With respect to real estate, the SIS is even more powerful. While it lacks the step-up in basis feature, it allows real estate investors to actually sell high and, at some point down the road, buy low. It can save a failed §1031 exchange from resulting in the immediate imposition of capital gains taxes and it can restore some independence and power to the seller/taxpayer, especially in volatile real estate markets. It can also take the proceeds of a huge financial windfall out of the taxable estate of a real estate investor. This piece has only scratched the surface in terms of the elegance, the simplicity, and the many applications, real estate and otherwise, of the Structured Installment Sale.

[11] Paul Sullivan,*How the Tax Code Rewrite Favors Real Estate Over Art*, New York Times (Jan. 12, 2018).

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