An Introduction to Structured Installment Sales

Avoiding Capital Gains Taxes on Real Estate Transactions or Business Buyouts

By Dan Finn

When the right set of circumstances presents itself, there may be no simpler way to defer, reduce, or completely eliminate long-term capital gains taxes when selling real estate, businesses, or certain other appreciated assets than a structured installment sale.

Internet searches for capital gains avoidance usually lead the general public to a handful of common strategies, with IRC section 1031 exchanges usually rising to the top of the list. Structured installment sales are less frequently included in that same discussion despite the long availability of this money-saving option. Simpler to implement than 1031 exchanges because there are no timing or like-kind requirements, structured installment sales permit a buyer to acquire a property, business, or certain other appreciated assets for cash (or via a traditional mortgage) while the seller can arrange to have the sales proceeds distributed according to a planned schedule created to anticipate more favorable future tax positions.

If planned properly, unlike many of the other options that focus mostly on tax deferral, a structured installment sale can eliminate taxes on gains altogether, even if the gain is significant.

Capital Gains Tax Efficiency

Since 2008, the lowest tax rate for long-term capital gains has been 0%. For 2021, it remains at 0% for those who fall below the established taxable income thresholds of $40,400 for single and $80,800 for married filing jointly (MFJ) taxpayers. Factoring in the $12,550 (single) and $25,100 (MFJ) standard deductions, however, the benefit of paying 0% capital gains taxes would be limited to those earning $52,950 (single) to $105,900 (MFJ) or less, ignoring any other offsets impacting their adjusted gross income (AGI).

Moving beyond those levels, taxpayers who can keep their modified adjusted gross income (MAGI) below $200,000 (single) and $250,000 (MFJ) can avoid the 3.8% net investment income tax (NIIT) they would otherwise owe if the structured installment sale is designed properly, even though they would cross over into the 15% bracket for some of their gain once the zero tax thresholds are eclipsed.

Even those taxpayers with significantly higher incomes can often still reduce their capital gains tax from 20% to 15% simply by structuring the sale. Once the 0% mark is exceeded, single taxpayers pay 15% on gain up to $445,850 ($501,600 for MFJ). Once above these levels, long-term capital gains taxes are capped at 20%. Taken altogether, the top marginal rate for long-term capital gains is 23.8%, not including state taxes that can push one's tax liability much higher. In California, the state with the highest capital gains tax rate, the top marginal combined rate is 38.10%.

This presents a tremendous opportunity for investors and business owners seeking to "cash out" in a tax-efficient manner. Investors with the flexibility to stagger their income—perhaps by deferring pension or Social Security payments at the same time they are selling a business or investment property—are prime candidates for structured installment sales.

Background

Structured installment sales evolved as an outgrowth of IRC section 453, which governs the selling of qualifying appreciated assets using the installment method where sellers can spread out recognition of capital gains over several years according to an agreed-upon schedule.

As originally conceived, installment sales function as a seller-financed purchase of the property or asset via a deed of trust, land contract, or similar evidence of debt: The buyer and seller agree to a sales price and payment terms for the transaction, which typically involves a negotiated interest rate component. The buyer agrees to make payments according to the terms of the contract and the seller pays taxes on capital gains and any interest earned each year as received. Taxpayers must file Form 6252, which accounts for the installment sale transaction, with their tax returns.

Installment sales can be fraught with risk to sellers who, while retaining the rights to the future payments and title should the buyer default, could find themselves reacquiring the same business or property they chose to let go in the first place. What if the buyer mismanages the business and ruins its value? Or if a natural disaster changes the character of an entire neighborhood forever destroying the real estate's value and appreciation potential? No seller wants to reclaim assets that have depreciated in value, hence the waning popularity of installment sales in recent years.

But what if sellers could derive all the benefits of installment sale tax treatment without the downside risk of buyer default? And what if they could time those future installment payments in anticipation of reducing their capital gains taxes from 20% to 15% or 0%? It turns out—they can.

Enter the Structured Installment Sale

A derivative of installment sales, structured installment sales began as an outgrowth of the structured settlement industry, which aids the resolution of personal injury lawsuits. In that arena, laws permit a plaintiff to arrange for their injury settlement proceeds to be paid over a period of time on a tax-advantaged basis while earning interest on their recovery. If their claim is for personal, physical injuries, future payments (principal and interest) are 100% income tax-free under IRC section 104(a)(2). If their settlement is for nonphysical injuries, all payments (principal and interest) are tax-deferred. Both these options remain extremely popular with lawyers and insurance companies, which regularly negotiate settlements and litigate civil personal injury disputes using them.

In the early 2000s, Allstate Life, then a leading life insurance provider of structured settlement annuities, began researching ways to expand the structured settlement marketplace by seeking alternative applications of the nonphysical injury structured settlement options they helped popularize. Their research led them to the aforementioned IRC section 453 governing the tax treatment of installment sales, creating what is today known as the structured installment sales industry. After reviewing the Installment Sales Revision Act of 1980 (H.R. 6883), which revised the rules for reporting gain on the sale of real and personal property under the installment method, and studying Revenue Rulings 75-457 and 82-122, which dealt with the substitution of obligors (an important concept to make structured installment sales work), Allstate was confident enough to roll out what they termed "structured sales" to its specially appointed agency force

Following Allstate's lead, Prudential released its own structured sale option; however, when the Great Recession wiped out a good deal of America's home equity and businesses were being sold for losses, the market for structured sales dried up. Prudential dropped its structured sale offering due to insufficient activity and Allstate made a corporate decision to exit the structured marketplace altogether in 2013, taking its promising structured installment sale option with it.

Fortunately, life company alternatives still exist today, with MetLife recently rolling out its structured installment sale option in several states and Independent Life also becoming active in this growing field. A structured installment sales option funded with United States Treasuries is also available. The industry remains hopeful that other life markets may soon enter or re-enter the marketplace. MetLife's decision to enter this lucrative market is especially noteworthy, given its position as one of the largest and most well-capitalized life insurers in the world.

Demand for structured installment sales resurfaced with the passage of the Tax Cuts and Jobs Act (TJCA) of 2017, which substantially lowered the threshold for triggering the 20% capital gains tax. This change, combined with real estate values having recovered from their post-recession nadir, make the structured installment sale concept an attractive alternative to traditional real estate and business sale transactions today.

The Mechanics

In order for structured installment sales to be successfully implemented, the property or asset must first qualify for installment sale tax treatment as outlined in IRS Publication 537, because not all transactions will be eligible. Among the types of transactions ineligible for installment sale tax treatment are the sale of inventory, stock, or securities; depreciation recapture; and other specifically referenced exclusions listed in Publication 537.

In addition, both buyer and seller will typically need to execute an acknowledgement statement and other disclosures as may be required by the provider of the structured installment sale product in advance of any deal moving forward, to ensure compliance with the issuer's requirements for acceptance. Parties will then formalize their intent to enter into an installment arrangement, usually through an addendum to the sales contract, the terms of which will also be incorporated into the accompanying nonqualified assignment that serves as the formal document necessary to perfect the transaction. Much of this, including direct funding of the annuity, can be accomplished at close of escrow as an extension of the normal closing process.

The nonqualified assignment document is a crucial piece of the structured installment sales transaction. Because one of the keys to tax deferral hinges on being able to avoid constructive receipt of income in the year of the sale lest the seller be taxed on the entire gain all at once, this document outlines those sums that are going to be paid in the future. And because the present value of these future periodic payments is funded by the portion of the sales proceeds one elects to defer, the seller can avoid recognizing the income until it is actually received in the future. To the buyer, however, everything is the same as it would be for a cash sale.

All of the above must be coordinated by a licensed, experienced, and specially appointed structured installment sales expert who will make sure the desired payout schedule is properly implemented and will oversee compliance with all requisite paperwork necessary to conclude the structured installment sale. Because these experts are compensated directly by the life insurance companies accepting the structured sale, there is no cost to either buyer or seller for their services. The negotiated price of the property remains unchanged, and parties receive no invoices for fees or costs at close of escrow.

Although the structured sales expert will be responsible for proper implementation of the transaction, the parties should consult with their own independent tax advisor for tax guidance and to ensure the optimum income deferral strategy to minimize taxes.

Sample Transaction

Jud and his wife Amy receive an unexpected $500,000 offer from a competitor to buy him out of the home maintenance scheduling business he established out of his Whittier, California garage 15 years ago. The turn-key operation nets them about $75,000 a year, which is sufficient to meet their needs. They paid off their house years ago, carry no debt, and have some modest savings set aside for retirement. Once they sell the business, they'll no longer itemize deductions and, at age 62, plan to use the sales proceeds to live off of until age 70, when they intend to initiate their deferred Social Security benefits and convert their retirement savings to guaranteed lifetime income.

Before accepting the offer, the couple call their CPA, who informs them they will owe approximately $131,500 in capital gains taxes from their $500,000 transaction if they sell this year. With eight years remaining before they trigger their Social Security and retirement savings income, they balk at the otherwise attractive offer. With interest rates so low, they determine that $368,500 (their net sales proceeds) will only generate about $46,000 a year over eight years if they keep the money in a bank, only about 60% of what they're accustomed to. They may as well keep the business for eight more years.

Before rejecting the offer outright, however, Amy reads something about structured installment sales, and they contact a specialist. The structured sales expert explains they can sell the business to the buyer for the same $500,000, but instead of receiving the entire purchase amount all at once, they can arrange to have the $500,000 used to purchase a structured installment sale annuity from a highly rated life insurance company that will pay them $70,000 per year for eight years. This $70,000 is a combination of the original $500,000 sales price ($62,500 per year) plus $60,000 in accumulated tax-deferred interest ($7,500 per year) for a total payout of $560,000. Because they are able to convert a one-time $500,000 capital gain into a series of eight annual mini–capital gains of $62,500 plus $7,500 interest, they're able to eliminate all their capital gains taxes, leaving a small portion of tax they will owe on the deferred interest, which will count as ordinary income.

Reducing a $131,500 capital gains tax bill to zero seals the deal for Jud and Amy. Even better, because the bulk (approximately 89%) of the $70,000 they receive each year is capital gains instead of ordinary income, they fall within the TCJA's 0% capital gain tax bracket and will only be taxed on $7,500 each year, versus the $75,000 salary they took as owners of the business. This puts them in the enviable position of netting more income each year, although their gross income is actually less. With their future income backed by the financial strength of a highly rated life insurance company, their bridge to retirement seems complete.

Although the greatest benefit may lie with those whose situations are similar to the preceding example, those who sell businesses or properties into the millions of dollars can still benefit a great deal even if they are high-wage earners. Many will find it attractive to move from an effective tax rate of 38.10% to something significantly less. Each situation is unique and warrants a comprehensive review.

Pandemic and Other Considerations

Although the coronavirus (COVID-19) will forever change how buyers and sellers of real estate and businesses approach transacting commerce in the future, the short-term lack of availability of businesses for sale may be the greatest impediment to implementing any type of transaction, let alone one using the structured installment method. There is, however, no evidence yet that the COVID-19 pandemic has had any negative impact on the mechanics of how deals are being done, save for the increased reliance on virtual signings and timing issues due to court closings and on-site appraisals. Most of the businesses supporting these industries have been deemed essential services.

Despite the understandable collective anxiousness of potential buyers and sellers, borrowing costs remain quite low, with interest rates at or near historic lows. This could create mutually beneficial low-cost buying opportunities for those eager to enter an industry that, when combined with selling incentives for others whose time horizon does not coincide with a potentially protracted recovery, could stimulate new sales activity. The real estate market has proven remarkably resilient thus far, with demand still outpacing supply.

Before entering into any real estate or business transaction, one must consider all aspects of the proposition. One primary drawback of structured installment sales is a lack of liquidity. Once the terms are built into the sales agreement and the deal is consummated, the future periodic payment terms become fixed and cannot be changed. The seller must also assume the risk that capital gains rates could increase beyond the more favorable levels currently in place through 2025.

Also, the feasibility and desirability of this tax deferral option will be driven by several other factors, including the size of the transaction, the current and projected future annual income levels anticipated by the seller, the potential for future changes to the tax code and tax brackets, and the seller's overall goals. A thorough analysis of the taxpayer's entire situation and a discussion of the risks versus rewards with a qualified tax advisor is always recommended.

Time to Lock in Gains?

It's a safe bet most people would gladly reduce a 20% tax liability to 15% or even 0% if doing so were convenient. With the ability to spread out tax liability over several years easily within reach, investors and business owners would be well advised to explore the option of a structured installment sale. The TCJA, combined with a prolonged bull run in the housing market, could make this the ideal time for investors to lock in real estate appreciation on investment property, or for business owners to transition to retirement while reducing or eliminating any capital gains taxes they would otherwise owe when they sell. Structured installment sales are not going to be a good fit for every transaction; but as a zero-cost option, those who qualify should strongly consider this easy-to-implement strategy among other tax saving alternatives. ■

***Dan Finn, CPCU, MSSC, RICP**, is the president and CEO of Finn Financial Group, LLC, Newport Beach, Calif., http://finnfinancialgroup.com.*