Real Estate *advisor*

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Know the tax consequences of an installment sale

In a slow real estate market where financing can be tough to obtain, some investors are finding they have a better chance of disposing of real property in an installment sale. When structured properly, this type of transaction provides some financial benefits to both buyer and seller. But you need to understand the ins and outs before you jump in.

Installment sale benefits

An installment sale occurs when you transfer property in exchange for a promissory note and receive at least one payment after the tax year of the sale. The beauty of such a sale is that it allows you to receive interest on the full amount of the promissory note, often at a rate that exceeds the rate you could earn from other types of investments, while simultaneously deferring your taxes and improving your cash flow.

You may be considered to have received a taxable payment even if the buyer doesn't pay you directly.

Installment arrangements can pay off for buyers, too. Buyers avoid paying the full amount upfront without dealing with the headaches of obtaining outside financing.

There may be some disadvantages for sellers, however. For instance, you might not get paid, so you'd have to deal with foreclosure. Or you might defer gain into a year when tax rates are higher, causing you to pay more tax overall. Remember, income tax rates are scheduled to increase in 2013 unless Congress acts.

The installment method

You generally must report an installment sale on your tax return under the "installment method." Each installment payment typically comprises three components:

1. Interest income,
2. Return of your adjusted basis in the property, and
3. Gain on the sale.

For every taxable year in which you receive an installment payment, you must report as income the interest and gain components.

Calculating taxable gain involves multiplying the amount of payments, excluding interest, received in the taxable year by the gross profit ratio for the sale. The gross profit ratio is equal to the gross profit (the selling price less your adjusted

basis) divided by the total contract price (the selling price less any qualifying indebtedness — mortgages, debts and other liabilities assumed or taken by the buyer — that doesn't exceed your basis).

The selling price includes the money and the fair market value of any other property you received for the sale of the property, selling expenses paid by the buyer and existing debt encumbering the property (regardless of whether the buyer assumes personal liability for it).

You may be considered to have received a taxable payment even if the buyer doesn't pay you directly. If the buyer assumes or pays any of your debts or expenses, it could be deemed a payment in the year of the sale. In many cases, though, the buyer's assumption of your debt is treated as a recovery of your basis, rather than a payment.

Dealers of time-shares and residential lots can report certain sales on the installment method if they elect to pay a special interest charge.

Your financial advisor may be able to help you structure your transactions to avoid this.

Many considerations

While an installment sale can be beneficial to you as well as the buyer, be aware that you can elect out of installment sale tax treatment and report all of the gain as income in the year of the sale. This might be preferable if you expect tax rates to increase or you have loss carryforwards or other carryforward deductions. The rules are complicated and there are many factors to consider, so discuss with your accountant or financial consultant whether an installment sale could work for you. ■

Does your mortgage exceed your basis?

If a buyer assumes an existing mortgage that's more than your installment sale basis in the property (see main article), you recover your entire basis. Therefore, the part of the mortgage that's greater than your basis is treated as a taxable payment received in the year of sale.

A wraparound mortgage, in which the principal includes the outstanding balance due on the property as well as the installment obligation on the sale, can help you avoid this scenario. The key is that the seller can't assume, or take the property subject to, the debt — you must remain liable for the underlying mortgage. The buyer makes payments to you based on the amount of the wraparound mortgage, and you use part of those payments to service your own debt.

Decisions, decisions

Options for minimizing exit costs from a CMBS loan

Commercial mortgage-backed securities (CMBS) loans provide real estate investors access to a larger pool of financing at lower rates than they could qualify for on their own. But when buying a property that you're financing with a CMBS loan, it's important to consider the consequences of *exiting* the loan.

Such forethought will be rewarded with greater flexibility and lower costs if you later decide to refinance or sell the property.

To sell or refinance a property before the term of its CMBS loan expires, you must first be released from your debt obligations. One way is to locate

a buyer with sufficient capital to assume your remaining debt. But this is often unrealistic and may even be prohibited by the loan agreement. Other routes to consider include: 1) yield maintenance and 2) defeasance.

Option 1: Yield maintenance

Under this option, you prepay the unpaid principal balance on your loan, including any prepayment penalty. Prepayment penalties on vintage CMBS loans are based on a percentage of the outstanding balance that declines over the term of your loan. More common today are prepayment penalties that allow the lender (or trustee, in the case of a securitization) to recover the same yield it would have earned if you'd made all payments on the loan through maturity.

The higher the loan rate and the lower the Treasury rate, the greater the penalty.

The penalty equals the net present value of the remaining payments multiplied by the difference between the loan's interest rate and the "replacement rate," typically the rate on the U.S. Treasury security that has the closest maturity date to the loan. The lender or trustee can then reinvest the prepaid principal balance in government securities to maintain its yield.

The higher the loan rate and the lower the Treasury rate, the greater the penalty. Why? In theory, the lender will now be left to invest its money in a Treasury security with a lower yield than the loan would have paid.

Even if the Treasury rate exceeds the loan rate, you'll probably incur a penalty. That's because yield maintenance provisions generally incorporate a minimum penalty of 1% to 3% of the outstanding balance. Minimum penalties dissuade you from prepaying or refinancing CMBS loans when interest rates drop.

Option 2: Defeasance

With defeasance, you substitute collateral — a portfolio of noncallable and nonprepayable U.S. government securities — for the real property that originally secured the loan. A successor borrower assumes the loan, and future payments come from the cash flow generated by the portfolio. The Real Estate Mortgage Investment Conduit (REMIC) prohibits defeasance for at least the first two years following securitization.

While defeasance usually imposes no formal prepayment penalty, you could incur a penalty embedded in the cost to purchase a portfolio that corresponds to the loan's debt service schedule. If the interest rate on the loan is greater than the Treasury rate on the substitute portfolio, the cost of the portfolio to cover the outstanding balance on the loan will exceed the outstanding balance. But if the Treasury rate is more than the loan rate, it will cost you less to purchase a substitute portfolio of government securities.

Regardless, you'll always incur transaction fees with defeasance. Compared to yield maintenance payoffs, defeasance is more administratively complex and time consuming.

Craft the loan document

The cost to exit a CMBS loan ultimately turns on current interest rates and the loan terms, and you can influence only one of those things. Loan provisions addressing yield maintenance should include an explicit formula for computing the penalty, with the replacement rate clearly defined and set as high as possible. A high replacement rate translates to a reduced penalty. Try to avoid any reference to a minimum prepayment penalty; if not possible, limit the minimum penalty to 1%.

From a defeasance perspective, you should retain the right to purchase the portfolio and include governmental agency securities in it. These can pay a higher yield than Treasury securities, which in turn can result in lower costs.

Existing CMBS loans

If you already have a CMBS loan in place that you want to get out of, it's probably too late to negotiate the exit terms. The current low Treasury rates will likely make yield maintenance a better option

because the cost of a portfolio for defeasance might exceed the loan's outstanding balance.

Defeasance will become more attractive if higher Treasury rates return, because you may be able to avoid a quasi-penalty and will definitely avoid a formal prepayment penalty.

Look down the road

Ideally, you should consider exit scenarios from CMBS loans at the outset so that you can secure favorable exit provisions. It can be difficult, if not impossible, to renegotiate loan terms. ■

How to leverage loss deductions when transferring FLP or LLC interests

Perhaps like many real estate investors, you hold properties in a family limited partnership (FLP) or limited liability company (LLC). In such a case, you're likely making transfers of ownership interests to family members in an effort to "shift" income to those in a lower tax bracket or to tax efficiently transfer wealth to the next generation. But, in the current economy, some properties held by an FLP or LLC may be generating operating losses. And that's where you need to be careful.

Beware the pitfalls

Transferring FLP and LLC interests to family members can provide opportunities to shift taxable income from a higher-income-tax-bracket

taxpayer to a lower-bracket one, as long as the recipient isn't subject to the "kiddie tax." (The kiddie tax is applied at the recipient's parents' marginal tax rate to unearned income in excess of $1,900 for 2012. Subject to the tax are children under age 19 and, except for those providing more than half of their own support, full-time students under age 24.)

You can still make a gift of an FLP or LLC interest and maximize the benefit of loss deductions. One way is to make gifts via an "intentionally defective" grantor trust.

But this income-shifting strategy can backfire if you're transferring interests in an FLP or LLC holding rental real estate that's operating at a loss for tax purposes: You may be transferring losses to a taxpayer whose tax benefit from the loss would be at a significantly lower rate or, worse yet, who doesn't have enough income to absorb the loss.

For example, if you're in the 35% tax bracket and you shift $25,000 in annual losses through a gift to your 25-year-old daughter in the 10% tax bracket, there's a 25-percentage-point differential in tax rates, resulting in $5,000 less tax benefit from the loss. Even worse, your daughter may not be able to currently deduct any of the loss because of the passive activity rules.

Unless she qualifies as a real estate professional, the losses will be passive to her. And she may not have any passive income and, as a result, likely won't qualify to deduct the loss. You, on the other hand, may have passive income to absorb the loss or qualify as a real estate professional for whom real estate activity losses are deductible against ordinary income.

Maximize loss deductions

You can still make a gift of an FLP or LLC interest and maximize the benefit of loss deductions. One way is to make gifts via an "intentionally defective" grantor trust (IDGT).

Instead of transferring the interest to an individual, you transfer it to the IDGT, which is designed to be a completed transfer for gift and estate tax purposes, but not for income tax purposes. So, while the asset is removed from your taxable estate for estate tax purposes, you continue to get the benefit of the losses from the interest owned by the trust. (Note that you also will continue to pay tax on any income the trust assets earn.)

Professional help helps

As you can see, transfers of FLP and LLC interests to family members can be tricky. Your CPA can help you maneuver through the maze of tax laws, so you can reach your intended goals. ■

Ask the Advisor

My commercial tenant just filed for bankruptcy — now what?

The uncertain economy is teaching landlords a hard lesson: Even reliable, long-time tenants can tread water for only so long, and bankruptcy is an inevitable reality for some. A tenant's bankruptcy filing has repercussions for its lease obligations, so you need to know what to expect and how to protect yourself.

Important deadlines

In a Chapter 7 liquidation, a tenant must assume or reject an unexpired lease within 60 days of filing or within any additional period granted by the bankruptcy court. In a Chapter 11 reorganization, the tenant typically has 120 days, which the court may extend 90 days without landlord consent. Further extensions require your consent. The tenant must make all payments due under the lease during the decision period. If it doesn't, you can get permission from the court to seek remedies, including repossession. But the tenant doesn't have to pay any outstanding rent obligations from *before* the bankruptcy filing to stay in possession.

Rejection

If the tenant doesn't make a decision by the applicable deadline, the lease is deemed to be rejected and you regain possession. If the tenant doesn't surrender the premises, don't take action to evict or you might be liable for your tenant's damages, including legal fees and possibly punitive damages. You must instead file a motion with the bankruptcy court. Similarly, if the tenant proactively decides to reject the lease, it must surrender the premises. The prefiling rent due remains outstanding, and you can file a claim for rejection damages if the lease has at least one year left.

Assumption or assignment

To assume the lease, the tenant must obtain bankruptcy court approval, cure all lease defaults and provide adequate assurance of future performance of the lease. If the tenant wishes to assign the lease, it first must assume the lease and then it can propose an assignee. Bankruptcy courts generally approve assignment, regardless of antiassignment clauses in your lease. You can object if:

- The assignee isn't as financially sound as the original tenant when the lease began,
- The tenant will alter percentage rent rates,
- The assignee will disrupt your tenant mix, or
- The assignment violates location, use or exclusivity provisions of your lease.

It's up to the judge to decide whether your objection is reasonable.

Act to protect yourself

Landlords should look for bankruptcy warning signs. Before a tenant's bankruptcy petition, you can file a complaint and terminate the lease, thereby reclaiming possession and sidestepping the bankruptcy process. But if bankruptcy strikes, take measures to enforce your rights. ■

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