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MEMORANDUM

TO: ELEVENTH ANNUAL REAL ESTATE SYMPOSIUM ATTENDEES

FROM: GEOFFREY N. TAYLOR, ESQ.

RE: CAPITAL GAINS DEFERRAL AND PRIVATE ANNUITIES

DATE: May 4, 2004

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Real estate investors often have significant unrealized gains in their properties. Even with the reduction in the tax rate for most long-term capital gains to 15%, investors generally seek to defer recognition of the gain where possible. Transactions can sometimes be structured as installment sales or private annuities to help achieve the goal of defined gain recognition.

In an installment sale, the owner sells the property pursuant to a payment plan in which at least one payment will be received after the year of sale. The buyer issues some form of evidence of indebtedness (e.g., a promissory note) and pays the purchase price of the property in installments. The installment sale allows the seller to stretch out capital gains taxes over the payment period (unless the seller elects out of installment treatment).

The amount of gain that is taxable in any given year is calculated by multiplying the payments received during that year by a fraction, the numerator of which equals the anticipated gross profit and the denominator of which equals the purchase price. For example, assume an owner sells real property with a basis of $100 in exchange for a promissory note with a principal amount of $500 that provides for 5 annual payments of $100 each. The seller's expected profit equals $400 ($500 sale price less $100 basis) and the profit ratio for each payment is therefore 80% ($400 expected profit divided by $500 sale price). The seller will recognize $80 ($100 payment multiplied by 80%) of capital gain each year. If the promissory note does not provide for interest, the IRS will "impute" interest and tax a portion of each payment received as ordinary income.

There is one very important limit however. Gain generally cannot be deferred in connection with an installment sale if the seller is a "dealer" (i.e., a person who sells real property in the ordinary course of the person's trade or business) such as a developer/seller of lots or a builder of new homes. If the property sold has been depreciated, recapture income cannot be deferred and must be recognized in the year of sale. The creditworthiness of the buyer is an important issue to the seller and a sizeable down payment (e.g., 20%) can protect the seller somewhat in the event the buyer defaults and foreclosure is required.

A private annuity is similar to an installment sale in that the purchase price for the property is paid over time. Payments can be made during the life of the seller, in which case the payments will be taxed as an annuity. Payments can also be made until the earlier of the seller's death or payment of a specified monetary amount. If the seller's life expectancy is less than the annuity period, the payments are taxed as an annuity (otherwise the payments will be taxed under the installment sale rules described above). Annuities are treated similarly to installment sales in that the recipient recognizes a portion of the total gain on the sale as each annuity payment is received. Gain on the sale will equal the excess of the present value of the annuity (using the seller's life expectancy) over the seller's basis in the property sold.

A specific type of private annuity arrangement involves a private annuity trust. The owner transfers the property to a trustee (e.g., a family member) and the trust in turn sells the property to a buyer for cash. The trust pays the seller for the property with a private annuity that provides for lifetime payments to the seller. The seller can defer the annuity payments until age 70 ½ . Unlike installment sales, depreciation recapture can also be deferred with a private annuity trust. To be prudent, the seller should have other sources of assets or income sufficient to support the seller in case the trustee makes bad investment choices or commits fraud.

If we can be of assistance in structuring an installment sale or private annuity transactions or if you are in need of advise pertaining to other sophisticated tax defined techniques, please contact me at (248) 827-1871 or gnt@maddinhauser.com.