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BUYING ON TIME
COMMERCIAL INSTALLMENT SALES

BY JERROLD J. STERN

One way to purchase or sell commercial real estate is through an installment approach. Installment sales can be attractive to both buyers and sellers. Buyers can defer their payments and benefit from leverage. Sellers can increase their cash flow. Moreover, if there is an impasse in negotiating the deal, an installment sale could produce a favorable outcome. Characteristics of the transaction, such as the interest rate and purchase price, can be manipulated to the benefit of both the buyer and seller.

Years ago, Seller purchased land for $600,000. Its current fair market value is $2 million. Buyer offers Seller an installment sale arrangement comprising a $200,000 down payment and a nine-year purchase money mortgage for the $1.8 million balance at a 6 percent interest rate. Buyer has a 35 percent marginal tax rate. Assume Buyer can earn 4 percent interest on an alternative (lower risk) investment.

The table illustrates the computations for a comparison between a cash sale and an installment sale. The computations demonstrate that, for Year 1, Seller is better off by 61 percent ($74,854 compared with $46,540) with an installment sale. Seller's extra return is almost entirely due to the higher interest rate on the purchase money mortgage.

Seller's returns decline over time as the mortgage is paid off, which could dampen Seller's enthusiasm about the installment sale. In that case, Buyer could offer a higher purchase price, a higher down payment and/or a higher interest rate. Of course, Buyer needs to be cognizant of the effect of these changes on his/her after-tax return.

Other issues to consider are summarized below.

Real Estate Dealers

Dealers cannot sell (inventory) property using the installment method. Thus, even though payments may be received over time, dealers must pay tax on all of the gain at ordinary tax rates in the year of sale. An exception in the law does allow installment sale treatment on dealer sales of unimproved residential lots.

Related Party Sales

Installment sale treatment is not available for sales between related parties — spouses, children, grandchildren, parents of the seller and certain businesses owned or partially owned by the seller. This rule is necessary to prevent a seller from deferring tax while the related party sells the property to a third party at its fair market value, generating a zero taxable gain. The zero gain is due to the tax basis of the property becoming equal to fair market value when the installment sale occurs.

Imputed Interest Rate

The seller may want to dramatically lower the mortgage interest rate and raise the purchase price. This would benefit the seller by converting ordinary interest income (taxed at ordinary tax rates) to capital gain income (taxed at 15 percent). (A higher purchase price would increase the amount of capital gain.) This strategy will work as long as the interest rate is not below the "applicable Federal rate" (AFR). If so, the AFR becomes the effective interest rate for tax purposes. Currently, the AFR for loans with terms of three to nine years is only 1.07 percent. For loans with terms over nine years, the AFR is 2.64 percent.

Installment sales can provide benefits to both buyers and sellers, but assistance from a competent tax accountant or tax attorney is advised.

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THE TAKEAWAY

Installment sales of commercial real estate can provide significant advantages for both buyers and sellers. Adjustments of contract terms such as interest rate, down payment and sales price can help close the deal.

Cash Sale vs. Installment Sale[1]

CASH		INSTALLMENT
$2,000,000	sale price	$2,000,000
$600,000	tax basis	$600,000
$1,400,000	gain	$1,400,000
$2,000,000	cash payment received by Seller	$200,000
–$210,000	less tax on cash sale: $1,400,000 × 15%	
	less Year 1 tax on installment sale at 15%[2]	–$21,000
$1,790,000	"immediate after-tax cash flow"	$179,000
$46,540	after-tax profit from investing "immediate after-tax cash flow" at 2.6%[3]	$4,654
	after-tax interest on $1,800,000 ($2 million – $200,000) mortgage principal at 3.9%[4]	$70,200
$46,540	year 1 after-tax cash earnings	$74,854

[1] *The new Texas rules regarding seller financing do not pertain to commercial real estate sales.*
[2] (200,000/2,000,000) × 1,400,000 × 15% = 21,000 [Additional computations would apply to sales over $5 million]
[3] Assumed 4% pretax interest rate from an alternative investment – (tax: 35% × 4%) = 2.6%
[4] Assumed 6% pretax interest rate on mortgage – (tax: 35% × 6%) = 3.9%

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