

# Alternative Tax Deferral options to TIC's and Real Estate 1031's

Recently investors have begun to explore the concept of "structured sale" as a way to defer taxes on the sale of their businesses, collectibles, and highly appreciated personal residence, vacation home, investment property or commercial real estate, without the constraints of finding a replacement property.

A structured sale, while a new term, is not necessarily a new concept. In its essence, it is a combination of two long-standing IRS codes: installment sales, and structured settlements.

Under an installment sale, a taxpayer has long been permitted by section 453 of the IRS code to arrange a sale of property the proceeds of which are taxable as received across several years.

The "structured settlement", and the whole Structured Settlement Industry, was created in the 1970's because of Internal Revenue Service rulings. These rulings made it clear that periodic payments to claimants in personal physical injury cases were free of federal taxation as long as certain conditions were met. This IRS acknowledgment made the concept of using periodic payments to help injured parties and defendants resolve claims popular. Before this time, U.S. common law



Leela Rao

promoted lump sum payments to claimants.

Listed below are the structured sale tax issues that had to be overcome in trying to combine these two separate concepts into this new unified concept.

The first basic issue is by virtue of the structured sale technique the buyer cannot be released from liability in the transaction. In other words the IRS is saying that when the buyer "assigns" its payment obligation to a third party in the structured sale agreement, this assignment cannot alter or otherwise

affect the terms of the buyer's original obligation. The IRS will look to see that the sole effect of the assignment under suggested structured sale agreement is to impose a payment obligation on the third party that is in addition to, not in substitution for, the original payment obligation of the buyer under the agreement.

Next, the structured sale cannot be at odds with either the "constructive receipt" or the "economic benefit" doctrines.

In this context, constructive receipt and economic benefit can be simplified to mean that if the seller has access (of any similar rights) to the funds then they are taxable at that time. IRS Code Section 453 has very specific rules on this and as long as they are followed the taxpayer should have no problems. The question is: does adding the structured settlement feature of the assignment by the buyer's obligations to a third party to make payments to the seller change this dynamic? Here is a summary of the issue to be aware of in this regard:

Under traditional constructive receipt principles, if payments are not credited to a seller's account, set apart for him or otherwise made available so he may draw on the settlement at any

time, there's no constructive receipt. Therefore, if a buyer assigns obligations to pay periodic payments to a seller, the seller should not experience any acceleration of gain. The essential point being that the buyer's assignment of its payment obligation to a third-party assignment company cannot give the seller any greater rights than he had under the installment agreement. So, in a structured sale, the third party's payments need to remain unsecured and not replace the liability of the buyer to make the periodic payments. If the buyer was already bound by an installment agreement under which the payments are taxable only in the year received, the buyer's receipt of payments from a third party (whose ability to make those payments are not secured) should not change the tax position of the seller.

From an economic benefit perspective the issue becomes that structured sale cannot do anything to alter the series of events first set in place when the seller negotiated for installment payments. The installment payments need to remain the same, the interest rate needs to remain the same, and the original obligor needs to be still obligated under the note. The only thing

Options to page 15

Diversity from page 9

option for 1031 exchange investing. Although working interest and royalty interest in existing oil and gas properties qualify for a 1031 exchange it is the royalty interest investments that seem to be the most popular for this space.

### Why are Oil and Gas Royalties a Popular 1031 Exchange Investment?

There are several reasons. Below are a few:

\* **Simplicity** - Oil and gas royalties typically do not have to be structured with the same complexity as do TIC offerings since they are not required to comply with the rigorous demands of revenue ruling 2002-22.

\* **Exposure** - Unlike real estate or working interests in oil and gas, royalty interest holders are not exposed to any liability issues and will never incur any expenses.

\* **No Leverage** - Oil and gas royalties typically do not have financing thus simplifying the process significantly. This also means that there is no chance of a foreclosure by a bank or lender.

\* **Low Minimums** - The minimums for oil and gas royalties are usually around \$100,000 and like TICs are flexible which gives investors the opportunity to put excess exchange money into a royalty offering should their other investment not match their entire exchange size.

\* **Diversification** - Oil and gas royalties are also diversified assets to those investors who feel over exposed to the real estate market.

### Satisfying a 1031 Exchange with a Balance of Both Energy and Real Estate

What often happens with those 1031 exchange investors who are exposed to energy royalties and find it a suitable investment is that they usually do an exchange with a balance of both energy and real estate often times using TIC properties as their real estate choice. Royalties are not a replacement for real estate rather a compliment. Each investment has a specific set of benefits and risks. Both investments can help investors retain what they have earned while giving them monthly cash flow with little effort. Investing in both allows investors to diversify

their exchange and spread out their risk by putting some of their funds into a commodity that has a very low correlation to the real estate markets, the national economy and interest rates.

TICs and Energy Royalties may not be suitable for every investor. It is important that you consult with an investment professional and determine what is suitable for you and your unique situation. However, if it is determined that these investments are suitable then you as an investor have opened the door to new 1031 exchange options.

*By: Dirk Todd is President of Madison Capital Investments LLC and a licensed securities representative (securities being offered by MCL Financial Group, Inc.). He holds a BA in Business from Ohio University and an MBA from Capital University. Dirk specializes in working with clients on 1031 exchange investment strategies.*

Options from page 3

that can change - and only be changed not through documents to which the seller is a party - is that the buyer's assignment of its obligations produces an additional obligor and a guarantor.

What this all seems to be saying is that as long as a structured sale plays by the same rules as installment sales, the concept of adding the feature of assignment from the structured settlement world should work. As with all things legal, and all things tax, running your situation by a professional with lots of letters after his name is recommended.

*Co-authored By: Leela Rao, Managing Director of Appreciated Asset Advisors and Rick Halperin, MBA, CPA, Managing Principal of Appreciated Asset Advisors.*

*This information is for educational use only. It is not a solicitation of securities products. Some of the strategies and options discussed and presented may involve significant risks, including illiquidity, and are intended primarily for accredited investors. This information presented should not be construed as legal or tax advice. It is strongly advised that you consult a tax or legal advisor regarding this information as it relates to your personal circumstances.*

*© 2007 Appreciated Asset Advisors.  
www.appreciatedassetadvisors.com*