THE WALL STREET JOURNAL.
WSJ.com

MONEY | March 21, 2007

Deconstructing a New Capital-Gains Strategy

'Structured Sales' Aim to Ease Tax Bite, but Returns Are Slim And Benefits Aren't Ensured

By RACHEL EMMA SILVERMAN

Eager to cash out of their real estate or businesses, some property sellers are being drawn to a new strategy to help put off paying capital-gains taxes.

The recent approach, called a structured sale, is being marketed more aggressively by some financial firms in the wake of the recent Internal Revenue Service clampdown on another tax-deferral strategy called a private annuity trust. The IRS and tax courts haven't yet opined specifically on structured sales. Some tax lawyers believe the strategy is likely to pass muster if it is implemented carefully, although there's always a risk the deals may be disallowed. The IRS declined to comment on the strategy.

Putting Off Paying

A new tax-deferral strategy works by spreading over several years the proceeds from selling an asset.

- The strategy can be useful for **older people** wanting a guaranteed income stream.
- The IRS hasn't opined on the approach, so there's a risk it **could be disallowed**.
- Low capital-gains rates might make it better to **pay the tax upfront**.

A structured sale essentially allows individuals to sell an asset today, and then receive over several years a stream of payments backed by an insurance company. Instead of paying the full tax bill at the time of sale, a portion of the taxes is paid each year that funds are received.

The market for structured sales is still small. But Allstate Corp., which began offering structured sales in recent years, says it expects the overall market to grow to about $14 billion within five years from about $100 million last year. Another big insurer, Prudential Financial Inc., also offers structured sales. A host of small financial firms around the country typically act as brokers to arrange the deals with individual consumers.

Critics say the strategy doesn't make sense for many property sellers. Costs can add up: The broker putting the deal together earns a commission, which is usually 4%, and there are typically set-up fees of between $500 and $1,500, plus legal and accounting fees. What's more, the seller's proceeds are essentially locked up in an annuity that currently pays about 4% to 5% (which is net of the commission). "Deferring the tax is great, but if your proceeds are stuck in a low rate-of-return annuity, then you are not doing yourself much good," says Atlanta tax lawyer Kevin McGrath, who has examined the transactions.

With federal capital-gains rates at historic lows of 15%, some advisers say it may be a better deal for some sellers to just pay taxes upfront and invest the money in vehicles that can yield higher returns. Also, if capital-gains rates were to rise, deferring the tax means you may end up paying higher rates in the future.

But proponents say structured sales make sense especially for older sellers willing to take lower returns in exchange for a guaranteed stream of income, or for people living in states with high capital-gains tax rates. Also, some individuals may have difficulty investing the proceeds of a large sale all at once. In that case, it also could make sense to put off the tax hit on the asset sale.

Jean Schwalbe, of Newport Beach, Calif., several months ago did a structured sale on a rental property that she sold for roughly $1 million. Ms. Schwalbe will receive payments over 15 years, at an interest rate of around 4.5%, according to the terms of the deal, which was set up by Capstone Bay LLC, a Denver firm that arranges structured sales. She will pay capital gains taxes gradually, as the installment payments arrive. "It was one way to ease the payment of the taxes," says Ms. Schwalbe, who is 70 years old. "Uncle Sam will still be getting some of my money, but it will be in smaller doses."

Structured sales are a new twist on the long-used tactic of installment sales, in which a buyer of a business or real estate agrees to make payments to a seller over a period of years. Sellers pay taxes only when they receive each installment. But if a buyer defaults, the seller can be left in the lurch.

Enter a large insurance company, such as Allstate or Prudential, which effectively backs the installment payments in a structured sale. The deals can be detailed and typically involve offshore affiliates of the insurers in Barbados, where the companies benefit from more favorable tax treatment.

In a structured sale, a buyer and seller agree to a series of installment payments. But the buyer, instead of making the installment payments himself, transfers his payment obligation to an affiliate of the insurance firm known as an assignment company. The assignment company then uses the buyer's cash to buy an annuity from the insurer, naming the seller as recipient, to cover the installment payments to the seller.

The strategy is usually employed for sales less than $5 million because federal tax rules impose an interest charge for installment sales above that amount per individual. (Allstate says that on average most of its structured sales have been under $1 million.) Often, sellers will do a structured sale for a portion of the sale and take upfront cash for the rest.

Sellers pay federal and state capital gains taxes on a portion of the payments, as they receive them, and pay ordinary income taxes, which are taxed at a higher rate, on the interest.

Tom Swegle, of Salt Lake City, recently did a structured transaction on the income from a tenant's lease-termination fee. Lesti Structured Settlements Inc., Los Altos, Calif., helped structure the deal so that Mr. Swegle received the income over a 15-year period, deferring the tax liability. At first, Mr. Swegle was wary of the untested nature of the transaction. "I'm a little old homeowner, and doing a deal where I'm having money coming through an unknown company out of Barbados was pretty adventuresome," says Mr. Swegle, 65 years old. "We were pretty nervous and pretty conservative about all this," he says, adding that he felt more comfortable after researching the transaction with his legal and tax counsel.

The deals are typically marketed through small financial firms. Mark Wahlstrom, owner of Wahlstrom & Associates in Scottsdale, Ariz., says he currently gets three to four inquiries a week about the deals, including from real-estate agents and financial professionals calling on behalf of clients, and from consumers directly. Cliff Brown, president of Capstone Bay, the Denver structured sales firm, says that he has deals worth about $50 million in the pipeline, up from just $5 million a year ago.

One reason for the growing interest: The IRS this fall issued proposed regulations that effectively ended another popular tax-deferral strategy called a private annuity trust, in which sellers exchange real estate or other property for an annuity issued by a trust. The IRS's proposed regulations essentially ended the capital-gains tax deferral for these deals.

The IRS's move caught many private annuity trust promoters by surprise, and some, in turn, have now turned to marketing structured sales or variations of the transactions.

Matt Brown, a tax lawyer in Irvine, Calif., says his biggest concern about structured sales is not whether the IRS will clamp down on the practice, but whether it makes economic sense for a particular individual. "I'd be perfectly comfortable recommending this structure to a client," he says.

Some critics argue that some less-than-scrupulous promoters are pushing the strategy to earn insurance commissions -- and might not be so careful about the tax formalities. "An industry has been created to help people avoid capital gains and that industry largely profits by selling insurance or annuities and earning commission," says lawyer and financial adviser Jay Adkisson, who founded the Web site quatloos.com, which provides information about various tax shelters.

Sales Tax

Sellers of appreciated property can choose from several options designed to defer or cut capital-gains taxes. Some strategies:

Strategy	How it works	Comment
Structured sale	A buyer and seller agree to a series of installment payments, which spreads seller's taxes over years. The buyer doesn't make payments directly to the seller, but instead transfers his obligation to a third party, who buys an annuity to cover the payments to the seller.	Structured sales are a variation of installment sales and have recently begun to be marketed. In an installment sale the buyer could default, but a structured sale reduces that risk because an insurer effectively backs the installment payments.
Charitable remainder trust	A donor transfers assets to a trust and receives a series of payments. At the end of the trust's term, what's left goes to a charity, for which the donor receives an upfront tax deduction.	This safe strategy can reduce capital-gains, income and estate taxes.
1031 exchange	The strategy allows you to defer capital-gains taxes by selling one property and quickly buying another similar property of equal or greater value.	1031 exchanges have grown very popular in recent years, especially for real estate, but they only work for commercial or investment assets and there are strict rules and deadlines.
Outright sale	Sellers have to pay capital-gains taxes right away.	Federal capital-gains tax rates are at a low 15% right now (although state taxes can increase the hit) so many people opt to simply sell outright, rather than setting up more complex arrangements.

Among the various complexities, a seller in a structured-sale arrangement can't be the owner of the annuity. The seller also isn't allowed to touch the buyer's money before receiving the installment payments, or this could trigger a tax hit. Another risk: Once you enter the transaction, the annuity payments generally can't be accelerated without collapsing the deal.

"If you don't have the right people doing it, you can certainly foul it up," says San Francisco tax lawyer Robert W. Wood, who has written several articles for tax journals about structured sales.

It's important to run the numbers with an independent financial adviser to see if a structured sale makes sense, depending on your income needs, age and tax situation. Also, make sure to get independent tax counsel, since the strategy is still untested from a tax perspective and there's always a risk it could be disallowed.

Other promoters are peddling alternative tax-deferral tactics, often involving trusts, partnerships, annuities or charitable entities strung together in convoluted ways. If you're approached by a tactic that seems dodgy, be wary and make sure to get independent tax and financial counsel before jumping in, or else you may be socked with taxes and penalties bigger than those you're trying to defer.

If you're more comfortable with tried-and-true tax deferral strategies, tax advisers recommend charitable remainder trusts, which generate income-tax deductions as well as capital-gains and estate-tax savings. There are also 1031 exchanges, in which property owners exchange one property for a similar one, but that's less attractive for individuals who want to exit commercial or investment real estate.

Write to Rachel Emma Silverman at rachel.silverman@wsj.com