Advice for Real Estate Investors—Maximize Your Tax Savings with Installment Sales

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If you've been looking at tax strategies regarding your real estate investments, one of the first lessons you probably learned is that it's good to defer your taxes. Why? Because even if you eventually have to pay those deferred taxes, you get a chance to invest more money early on and take advantage of that growth, rather than losing it right away to taxes.

How the Installment Sale Works

If you're a real estate investor (sorry dealers—this one's not for you), you can take advantage of installment sales in order to defer part of the taxes you owe on the sale of your real estate property (or personal property). Doing it this way, you as the seller don't have to report all the gains on the sale before you actually receive all the sale proceeds. The only catch is that at least one payment in the installment must be received *after* the year that's taxable regarding the sale. If the payments are so large that the entire amount is paid within the same taxable year, you lose out on this advantage.

Here's the easy formula for how much you'll report each year in taxable gains on the installment payments:

Total Annual Principal Payments **x** *(Gross Profit / Total Contract Price)*

Those *principal payments* include any of your existing loan indebtedness that the buyer is subject to, to the extent that it **exceeds** your adjusted tax basis. In the case that you do have an existing loan, the buyer is not personally liable to your lender (in contrast to when a buyer assumes a loan). This is called a **wraparound mortgage** because the buyer is taking a loan on a property on which you already have a mortgage loan, and instead of you receiving the full amount of the sale proceeds to pay off your existing mortgage, your lender continues to receive payments.

To get the *gross profit* amount for the equation above, you take the selling price minus the property's basis and selling expenses. This number is the total gain you will report of the course of the installment period.

Total contract price is the sum of all principal payments you will receive throughout the entire course of the installment period. It is calculated by taking the selling price minus liabilities assumed by the buyer that do **not** exceed your basis (including selling expenses).

Advantages

There are two primary advantages to using the installment method for a wraparound mortgage:

1. You may be able to reduce the amount of the payments you receive in the year of the sale (during which time your existing mortgage may exceed your basis).
2. The contract price may include the face amount of the wraparound mortgage (increasing the contract price in the equation above decreases the percentage of gains you pay taxes on).

You may notice that these advantages do not reduce the amount of gains you will pay taxes on in total. However, they do help you to defer a larger amount of your taxes. You will only incur tax as each installment payment is actually made on the principal (including any down payment). If you get the buyer to agree to pay the closing costs, you can get even bigger tax savings. How? It’s because the closing costs come out of the down payment paid by the buyer.

For example, if the buyer was paying you $35,000 as a down payment, and you pay the closing costs, then the entire $35,000 is taxable. However, if you get the buyer to agree to pay closing costs (and reduce you reduce the sales price and down payment accordingly), they could still pay $35,000, but you will only pay taxes on that amount *less the closing costs*.

In order for this to work, you cannot be liable for the brokerage commissions. If you are, then having the buyer pay those costs means they are assuming your liability. And, the tax court has ruled that if a buyer assumes your obligation to pay brokerage commissions, that money counts as a payment received by you in the year of the sale. Pay attention here: *that negates any tax benefit you would receive from having the buyer pay closing costs.*

So, how do you fix this? It’s actually quite easy. When your broker lists the property for sale, make it clear that they should look to the buyer for payment of the brokerage commission rather than making these costs part of the bargaining between you and the buyer. When you plan ahead and state this up-front, *you don’t have any obligation for the buyer to assume* (i.e. you were never obligated to pay this in the first place). It shouldn’t be too hard for you to get a buyer to agree to such a situation. They will still be in pretty much the same financial scenario either way. But, the second strategy gives you a tax break in the year of sale.

Seller Beware

The main benefit of this whole strategy is your tax-deferral ability. While you are deferring these taxes, you are also earning interest on the installment payments. But, the IRS knows that you are earning interest on its deferred tax dollars. So, you should be aware that for large transactions, **you** can be charged interest on that deferred tax under installment reporting law (for situations where the sales price is more than $150,000 and the total installment obligations are more than $5 million).[1]

Several court cases have attempted to disallow this strategy; however, the sticking point in these cases has been the documentation. When you’re considering the installment method with a wraparound mortgage, make sure you hire a legal professional to help you draft all the documentation. The buyer’s obligation to pay closing costs should be clearly stated in the purchase agreement, so that you can keep the additional tax savings. Above all, make sure the installment method is the right method for your situation by checking the numbers and seeing what kind of tax savings you’re looking at.

1. IRS Publication 537 ^