

Installment Sale

"TAX DYNAMITE"

What is The "Installment Sale?"

The Installment Sale is a method of reporting income that has not been received in cash, income that is carried in a note, Trust Deed, or Mortgage, All Inclusive Trust Deed or Contract of Sale, on a property that the Tax Payor has sold and carried paper on. The installment sale is a method of reporting taxes, not an INSTRUMENT FOR PASSING TITLE. The installment sale was created for taxpayers who would be carrying all or part of the cash value of their property, in paper, upon the sale of that particular property. The Installment Sale of Tax Reporting was also created to encourage owners to carry paper on the sale of their real property. This helps to expand the economy in the private sector, creating more sales and more money, as well as helping to secure income for taxpayers, making them more financially independent and ultimately creates greater income taxes to be collected by the Federal and most State Governmental agencies. You find Installment Reporting under Internal Revenue Code §453.

What the Installment Sale is supposed to do is create a situation where the tax payor can pay any taxes due when he/she actually receives the cash. It is not meant to be a tax savings device, it is simply meant to defer the taxes due on notes carried to the day when those notes are changed to cash.

Within The Installment Sale We Have Two Types of Income

Within the installment sale we have two types of income, principal and interest. The two types are differentiated because the method of taxation is normally different for the two. Principal is normally taxed at a lower rate, and interest is normally taxed at a higher rate. Therefore it becomes important to distinguish between what is principal and what is interest.

THE TWO TYPES OF INCOME IN THE INSTALLMENT SALE;

1. Principal
2. Interest

PRINCIPAL:

Principal is the money that was loaned. Principal payments are the money paid, or returned on the actual value of the note. In other words any principal payments would reduce the amount of the note by the amount of the principal payment. For example, if you had a \$100,000 note at 10% interest and you received a principal payment in the amount of \$10,000 the note would be reduced to \$90,000. Principal payments reduce the amount of the note.

INTEREST:

Interest is the money that is earned by virtue of the fact that you have the note. Think of interest as rent being charged on the face amount of the note, or the money that was loaned. In other words, our note mentioned above is \$100,000 at 10% interest, this means that the note is earning 10% of its face value annually, or \$10,000 annually. Interest does not pay the face amount of the note off or down, it simply pays the rent on the note.

What The Installment Sale Can Do For The Tax Payor

The installment sale defers a certain portion of the taxes that would normally have to be paid, this means that the tax payor can use that tax money, the taxes that would have been due had he/she received it in cash, to earn additional income as interest. This is the key advantage in the installment sale, the tax payer is able to collect interest on taxes that he/she would normally have paid. He/she is able to collect the interest on the deferred taxes until the note is paid off. When the note is paid off, the taxpayer will have to pay the taxes that were due on the note. This deserves a small example.

The Advantage is the Interest Earned on the Unpaid Taxes

For Example:

If a Tax Payer sold a building that was free and clear, no loans, for \$1,000,000 and that building had an adjusted tax basis of \$100,000, and assuming no expenses of sale, we could compare an after tax earning from the proceeds of the sale using the Installment Sale and an all cash sale. Let's create two situations.

Situation I:

The Seller sells the building for all cash. He/she pays the taxes and then places their After Tax Cash, ATC in a 8% interest bearing bank account. What will he/she have in 10 years assuming no taxes due on the interest earned.

Situation II:

The Seller sells the building with no down payment, he/she carries the entire \$1,000,000 at 8% interest for a 10 year period and then the note is paid off, at that time he/she will have to pay the taxes that are due on the note.

Installment Sale and Cash Sale Compared for A 10 Year Period

	<u>Situation I</u>	<u>Situation II</u>
Selling Price of Building \$1,000,000	\$1,000,000	
Less Estimated Taxes on Gain	<u>(\$ 423,155)</u>	<u>(\$ None Now)</u>
 AFTER TAX NET, YEAR OF SALE	 <u>\$ 576,845</u>	 <u>\$1,000,000</u>

In both situations the after sale cash is earning 8% interest, which is Passive Income, Passive Income can be off set, sheltered, by Passive Loss from other real estate owned. Regardless, following is the interest earnings from the after tax principal in the two Situations.

<u>Year</u>	<u>Situation I Interest</u>	<u>Situation II Interest</u>
1.	\$ 46,148	\$ 80,000
2.	\$ 46,148	\$ 80,000
3.	\$ 46,148	\$ 80,000
4.	\$ 46,148	\$ 80,000
5.	\$ 46,148	\$ 80,000
6.	\$ 46,148	\$ 80,000
7.	\$ 46,148	\$ 80,000
8.	\$ 46,148	\$ 80,000
9.	\$ 46,148	\$ 80,000
10.	<u>\$ 46,148</u>	<u>\$ 80,000</u>
Total 10 Year Interest Earned	\$ 461,480	\$ 800,000
Principal Remaining	\$ 576,845	\$1,000,000
Less Taxes on Principal	<u>(\$ Paid)</u>	<u>(\$ 423,155)</u>
 10 Year Totals	 <u>\$1,038,325</u>	 <u>\$1,376,845</u>

You immediately see that Situation II has earned \$338,520, which is exactly 8% of the unpaid taxes, taxes that were not due until the \$1,000,000 note was paid off, and those taxes earned the difference in situation II. This is the primary advantage of the Installment Sale. The Installment Sale has many advantageous uses. It is probably the most unused tax tool in estate planning where the sale of real property is involved.

When to Use the Installment Sale
What Is IT For, What Can It Do

The Use of the Installment Sale is Particularly Suited For;

1. Creating Greater Retirement Incomes.
2. Increasing Immediate Spendable Income.
3. Increasing the Value of the Real Estate to be Sold by using;
 - a. Low Down Payments
 - b. Low Interest Rates
4. When an owner is thinking of cashing out of more than one building, sell the one with the least write-off and further shelter this "Passive Interest Income" with the Passive Loss from their other buildings. He/she is still entitled to deduct \$25,000 against their Active Income, (Ordinary Income) if there is enough write-off.
5. For the Active Investor who can usually use additional spendable income, who is still buying and trading, with the bulk of their equity. As in the combined Installment Sale/Exchange.

Some Rules for The Installment Sale

- A. Installment Sales are not usable by Dealers. That is people who hold product with the intent of selling it immediately for a profit. People or companies who are classified as dealers. In other words, the Installment Sale is only for Non-Dealers.
- B. Dealer = a person, or company who held property for trade or business, or for the production of rental income, and then only if the sales price exceeds \$150,000. Land is still privy to installment treatment no matter how it was held, or who held it. (Dealer or Non-Dealer)
- C. Interest will be charged by the Internal Revenue Service, on the deferred tax, if the face amount of all obligations arising during a year exceeds \$5,000,000 at year end. The interest is charged only on the amount exceeding \$5,000,000.

NOTE: This interest is the treatment that Dealers get if they elect to use the Installment Sale. A Dealer may use Installment reporting, but has to pay interest on the deferred taxes. The interest charged on the deferred taxes is the Federal Short Term Rate plus 3%, figured the month you file your tax return. For November 1993 the Short Term Rate was 2.76%, then add 3% = 5.76% for Dealers.

- D. The interest generated from Installment Notes is Passive Interest Income.
- E. If the notes carried are: Sold - Borrowed Against (Hypothecated) - or pledged, the proceeds or pledge value will be treated as cash received and that amount becomes immediately taxable.

USE AND MANIPULATION OF THE INSTALLMENT SALE

To compute the Installment Sale you have to go through 5 Basic Steps;

1. Find the Adjusted Tax Basis of the Property in Question.
2. Find The Gross Profit.
3. Find The Contract Price of the Property in Question.
4. Find The GROSS PROFIT RATIO.
5. Establish, or find, the taxable cash payment received in the year of the sale.

You Have to Know The Adjusted Tax Basis

The Adjusted Tax Basis is always found the same way, it is the same for a straight sale, exchange or installment sale.

The Adjusted Tax Basis is the Original Purchase Price, Plus any acquisition Costs, Plus any Capital Improvements, Less any Depreciation Taken.

Adjusted Tax Basis = Purchase Price + Acquisition Costs + Capital Improvements - Depreciation Taken

Purchase Price of Building	\$
Plus Acquisition Costs	\$
Plus Any Capital Improvements	\$
Less Any Depreciation Taken	<u>(\$ _____)</u>
ADJUSTED TAX BASIS OF PROPERTY	<u><u>\$</u></u>

To accurately figure the Installment Sale you have to know the Adjusted Tax Basis,

in most cases this will come from your client, or your clients Tax Preparer. If the accountant does the figures for the Installment Sales, they may or may not be right, if they do then get out of their way, your job is selling real property, not figuring taxes. The problem here is that you may do five or six Installment Sales a year when the Installment Sale has a popular period, is in high regard, and the tax accountant will probably do one every ten years. Regardless, keep the egos separated. (You will find a blank in-depth worksheet on Page 177 of this text.)

Step I: Find The Gross Profit

Gross Sales Price	\$
Less the Adjusted Tax Basis	(\$)
Less Any Selling Costs	<u>(\$)</u>
 This gives you the Realized Gain	 <u><u>\$</u></u>
 Less any Recapture	 (\$)
 GROSS PROFIT RATIO	 <u><u>\$</u></u>

Step II: Find The Contract Price

[There are Four (4) Possibilities for the Contract Price]

1. If the building is free and clear, the contract price and the sales price are one and the same.
2. If the property has a mortgage, and the mortgage is Paid Off, or Assumed, or Taken Subject To by the buyer, so that the Seller has no responsibility or liability to pay on that mortgage, and the Buyer does have the responsibility, the Contract Price is the Gross Sales Price, less any mortgage paid off, assumed, or taken subject to.
3. If the property has a mortgage, and the mortgage is not assumed by the Buyer, the Buyer has no responsibility to pay that mortgage, the responsibility remains with the Seller, the CONTRACT PRICE AND THE SELLING PRICE ARE THE SAME. Further, there would be no excess of mortgage over basis relief. (¹ Footnote)
4. If the mortgage is greater than the tax basis, (EXCESS OF MORTGAGE OVER BASIS) and the mortgage is paid off or assumed by the buyer, the Contract Price is the Selling Price, Less That Mortgage, Plus any Excess of Mortgage Over Basis. (This EXCESS OF MORTGAGE OVER BASIS IS ALSO CALCULATED LN THE DOWN PAYMENT AND IS TAXABLE IN THE YEAR OF THE SALE.)

DEFINITION - "Excess of Mortgage Over Basis"

¹ This issue was challenged by the I.R.S., they claimed this did not matter. The courts in a case I can't recall said I.R.S. had no right to make a ruling on this matter. There is a tremendous advantage if this is usable again, as keeping the contract price high, lowers the Gross profit Ratio and literally avoids taxes if uses properly.

Mortgage Over Basis is simply when the mortgage exceeds the Adjusted Tax Basis of the Property. This indicates that the owner has refinanced the property, or taken an accelerated method of depreciation. Excess of Mortgage Over Basis is inherent in the Installment Sale only. It is often confused with "Mortgage Relief", which is found only in the IRC 1031 Tax Deferred Exchange.

Step II: Find The Contract Price

Gross Sales Price		\$
Less Mortgages Assumed By Buyer		(\$)
Plus any Excess of Mortgage Over Basis		<u>(\$)</u>
CONTRACT PRICE		<u> </u>

Step III Find the "Gross Profit Ratio"

The "GROSS PROFIT RATIO" is a percentage that we get by dividing the Gross Profit by the Contract Price. The "Gross Profit Ratio" is used to multiply any principal received to find out what the taxable part of the principal is. In other words, if we get \$100,000 of principal, and our Gross Profit Ratio is 50%, we would multiply the \$100,000 X 50% = \$50,000, the \$50,000 would be taxable. The Gross Profit Ratio cannot exceed 100%, if it does, use 100%. Your in-depth worksheet is on page 177 of this text.)

$$\frac{\text{Gross Profit}}{\text{Contract Price}} = \text{Gross Profit Ratio} \quad \frac{\$ \text{---}}{\$} = \%$$

Step IV: Find Total Payments Year of Sale

Down Payment		\$
Plus Net From New institutional Loan (New 1st T.D. Less Old Loans)		(\$)
Plus Any Principal Payments on Loan in Year of Sale		\$
Plus Any Excess of Mortgage Over Basis		<u> </u>
TOTAL PAYMENTS IN YEAR OF SALE		<u> </u>

Use of the Gross Profit Ratio

The "Gross Profit Ratio" is a percentage used to multiply any principal received, it will give you the amount of that principal that is taxable. You would then apply the applicable tax rate for that tax payer to find the taxes that are due.

Example of an Installment Sale

You have a Seller who owns a 10 Unit Apartment Building. The Building consists of Four (4) 2 Bedroom, 2 Bath units with a current rent of \$600 per month and a current market rent of \$750 per month, four (4) 2 Bedroom, 1 Bath units with a current rent of \$575 per month and a current Fair Market Rent of \$725 per month, and two (2) 1 Bedroom, 1 Bath units with a current rent of \$525 per month, and a current Fair Market Rent of \$650 per month.

The owner purchased the building in 1974, for \$100,000 and acquisition costs of \$1,500, he/she put \$20,000 down and got a new 1st Trust Deed and Note for \$80,000 at 8.5% interest, a fixed rate loan, amortized for 30 years, and payable in equal monthly installments of \$615.13, their current loan balance is \$49,613.66. When he/she purchased the building their accountant used a 50% Improvement Value, and used 25 year Straight Line Depreciation, he/she has depreciated \$2,000 a year for the past 20 years.

He/she indicates that he/she is going to retire and would like to have some cash now and carry a Trust Deed on the building. He/she knows that this will supplement their income, that he/she can get a higher interest rate on a trust deed than he/she can from a bank account. He/she is going to retire on \$800 a month from Social Security and would like as much additional income as he/she can get. He/she doesn't want any more management problems. We will estimate that for the income years of this example, the years between year 2 and year 9, for income tax purposes he/she is in a combined, Federal and State, Marginal Income Tax Bracket of 32%. (For the Year of Sale Marginal State & Federal Tax Bracket we would estimate 40.62% this should be true in the 10th year, the year the note is paid off, however, we will figure it for accuracy at that time.)

Current Cash Flow From the Building at Current Rents

Gross Scheduled Income	\$69,000	
Vacancy Factor 5%	(\$ 3,450)	
Gross Operating Income	\$65,550	
Expenses 25% of G.S.I.	(\$17,250)	
Net Operating Income	\$48,300	
1st Trust Deed Payments	<u>(\$ 7,382)</u>	= \$ 49,613.66 @
8½%		
Cash Flow	<u>\$40,918</u>	

Buildings Tax Picture This Year

Gross Scheduled Income	\$69,000
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Less Vacancy Factor	(\$ 3,450)	
Less Expenses of Operation	(\$17,250)	
Less Depreciation	(\$ 2,050)	
Less Interest 1st Trust Deed	<u>(\$ 4,090)</u>	
Total Deductions	(\$26,840)	<u>(\$26,840)</u>
Net Tax Loss or Gain		<u>\$42,160</u>

The net tax loss or gain line, lacking brackets, tells us that regardless of the cash flow of \$40,918, the taxable income is \$42,160. This is \$1,242 more in taxable income than in the actual cash flow. This difference is because the Equity Build Up, or Loan Paydown, on the first trust deed is treated as taxable cash. A really simple way of finding the Net Tax Loss or Gain in any give year is;

CASH FLOW - EQUITY BUILD UP + DEPRECIATION = NET TAX LOSS OR GAIN THAT YEAR

AFTER TAX RETIREMENT INCOME WITH THE BUILDING

It is prudent for a knowledgeable broker to be able to explain the before and after tax cash flow to a client who is anticipating an Installment Sale, you should be able to show them what their after tax cash flow picture will be with the building and what their after tax cash flow will be if they sell the building using the Installment sale.

Cash Flow From Building	\$40,918		
Social Security Income	<u>\$ 4,800</u> ²		
Adjusted Gross Income	<u>\$45,718</u>		
Estimated State & Federal Taxes	(\$14,311)	=	28.33%
Marginal			
Plus Untaxed ½ of Social Security	<u>\$ 4,800</u>		
After Tax Income From Building & Social Security	<u>\$36,207</u>		

You Appraise The Building For an Installment Sale

Here You Would Appraise on "Fair Market Rents"

² Social Security Income is taxable up to ½ if other income is in excess of \$25,000.

	Gross Scheduled Income	\$86,400		
	Vacancy Factor 5%	(\$ 4,320)		
	Gross Operating Income	\$82,080		
	Expenses of Operation 30%	(\$25,920) ³		
	Net Operating Income	\$56,160		
8.5%	New 1st Trust Deed and Note	(\$18,454)	=	\$200,000 @
	Sub-Total Net	\$37,706)		
@8%	Seller Carried 2nd Trust Deed	<u>(\$32,000)</u>	=	<u>\$400,000</u>
	Cash Flow	<u>\$ 5,706</u>		
	Total Loans			\$600,000
	Cash Down Payment 25%			<u>\$200,000</u>
	Selling Price or Value of Building			<u>\$800,000</u>

NET CASH AND PAPER, CLOSE OF ESCROW

Selling Price of Building	\$800,000
Less Expenses of Sale 7½%	(\$ 60,000)
Less Loans of Record, 1st Trust Deed	<u>(\$ 49,614)</u>
Net Cash & Paper, Close of Escrow	\$690,386
Paper Carried	\$400,000
Net Cash Close of Escrow	\$290,386

Now you have the necessary information to start figuring the impact of the installment sale. You have all of the numbers that you need. You will start with Step I: Find The Adjusted Tax Basis.

FIND THE ADJUSTED TAX BASIS

Original Purchase Price of Building	\$100,000
Plus Acquisition Costs	\$ 1,500

³ The Taxpayers expenses were 25% of Gross Scheduled Income, this is because he was operating the building well below market rents, this has the effect of tenants not reporting work to be done or doing it themselves to avoid rent raises. When rents are at market, tenants will report every problem, and expect it to be resolved, fixed.

Less Any Depreciation Taken	(\$ 40,000)
Plus Any Capital Improvements	<u>\$ -0-</u>
ADJUSTED TAX BASIS OF BUILDING	<u>\$ 61,500</u>

STEP I: FIND THE GROSS PROFIT

Sales Price of Building	\$800,000
Less Expenses of Sale	(\$ 60,000)
Less Adjusted Tax Basis	<u>(\$ 61,500)</u>
GROSS PROFIT	<u>\$678,500</u>

STEP II: FIND THE CONTRACT PRICE

Gross Sales Price	\$800,000
Less Any Encumbrances of Record	(\$ 59,744)
Plus Any Excess of Mortgage Over Basis	<u>(\$ -0-)</u>
CONTRACT PRICE	<u>\$740,256</u>

STEP III: FIND THE GROSS PROFIT RATIO

$$\frac{\text{Net Gain}}{\text{Contract Price}} = \text{Gross Profit Ratio or;} \quad \frac{\$678,500}{\$740,256} = 91.66\%$$

You now know that 91.66% of any principal payments will be taxable at whatever Marginal Bracket your client is in. The real Gross Profit Ratio is 91.6574807, we have rounded the number, this will cause a small inaccuracy.

STEP IV: FIND THE TAXABLE CASH IN THE YEAR OF THE SALE

Gross Down Payment at Purchase	\$200,000
Plus Net from New Institutional Loan	\$140,256
Plus Any Principal Payments in Year of Sale	\$ -0-
Plus Any Excess of Mortgage Over Basis	<u>\$ -0-</u>
TAXABLE CASH RECEIVED YEAR OF SALE	<u>\$340,256</u>

FIND THE CASH SUBJECT TO TAXES, YEAR OF SALE

Cash Received	X	Gross Profit Ratio	=	Taxable Cash in Year of Sale
		More Accurately;		
Principal Received	X	Gross Profit Ratio	=	Taxable Principal
\$340,256	X	91.66%	=	\$311,879

FIND ESTIMATED TAXES DUE, YEAR OF SALE

Taxable Cash	X	Marginal Bracket	=	Taxes Due, Year of Sale
\$311,879	X	40.62	=	\$126,694

AFTER TAX CASH NET, YEAR OF SALE

After Sale Cash Net, Year of Sale	\$340,256
Less Taxes Due, Year of Sale	<u>(\$126,694)</u>
AFTER TAX CASH, YEAR OF SALE	<u>\$213,562</u>

For Investment purposes, we will place this \$213,562 in a 7% interest bearing bank account, pay the estimated taxes due each year in our 32% Marginal Income Tax Bracket, and finally figure out just where our seller is from an after tax standpoint in this installment sale we have arranged.

PAYMENTS ON THE \$400,000 NOTE

The payments on the \$400,000 note at 8%, interest only are made monthly, in the amount of \$1,666.67 per month. Your client gets a check from Social Security in the amount of \$800 per month, and the After Tax Cash Net from the year of the sale, the \$213,562 is sitting in a 7% interest bearing bank account, with monthly payments of \$1,245.78.

TOTAL BEFORE TAX INCOME
WITH THE BUILDING OWNED & THE BUILDING SOLD

<u>GROSS ANNUAL</u> <u>INCOME FROM BUILDING</u>	<u>GROSS MONTHLY INCOME</u> <u>FROM INSTALLMENT SALE</u>
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Cash Flow From Building	\$ 40,918	\$ -0-
Social Security Income	\$ 9,600	\$ 9,600
Income 7% Bank Account	\$ -0-	\$ 14,949
Income \$400,000 Note	<u>\$ -0-</u>	<u>\$ 32,000</u>
Before Tax Income	<u>\$ 50,518</u>	<u>\$ 56,549</u>

**TOTAL AFTER TAX INCOME
WITH THE BUILDING & WITH THE INSTALLMENT SALE**

	<u>AFTER TAX NET WITH THE BUILDING</u>	<u>AFTER TAX NET INSTALLMENT SALE</u>
Cash Flow Building	\$ 27,909	\$ -0-
Social Security Income	\$ 8,298	\$ 8,298
7% Bank Account	\$ -0-	\$ 10,459
\$400,000 2nd T.D.	<u>\$ -0-</u>	<u>\$ 21,375</u>
After Tax Income	<u>\$ 36,207</u>	<u>\$ 40,132</u>

Your Investor is ahead in after tax income this year by \$3,725 after selling the building. If he/she was prudent in raising their rents, and he/she's not, he/she could do better with the building, but this is unlikely as he/she told you he/she didn't want anymore management problems.

TOTAL 10 YEAR EARNINGS, INSTALLMENT SALE & REGULAR SALE

Generally for a client you are doing a comparison between a Regular Sale and an Installment Sale. We haven't done a regular sale yet, so let's do one. Then we can compare the differences.

You Appraise The Building For a Regular Sale

Gross Scheduled Income	\$86,400
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Vacancy Factor 5%	(\$ 4,320)	
Gross Operating Income	\$82,080	
Expenses of Operation 30%	(\$56,160)	
Net Operating Income	\$58,752	
New 1st Trust Deed and Note	<u>(\$55,362)</u>	= <u>\$600,000 @ 8.5%</u>
Cash Flow	<u>\$ 3,390</u>	
Total Loans		\$600,000
Cash Down Payment 25%		<u>\$200,000</u>
Selling Price or Value of Building		<u>\$800,000</u>

Net Cash Close of Escrow, Regular Sale

Selling Price of Building	\$800,000
Less Expenses of Sale	(\$ 60,000)
Less Loans of Record	<u>(\$ 49,613)</u>
NET CASH CLOSE OF ESCROW	<u>\$690,387</u>

Gain, or Taxable Cash Year of Sale

Selling price of Building	\$800,000
Less Expenses of Sale	(\$ 60,000)
Less Adjusted Tax Basis	<u>(\$ 61,500)</u>
RECOGNIZED GAIN	<u>\$675,500</u>

Estimated Taxes Due on Sale

NET GAIN	X	[FEDERAL BRACKET + STATE BRACKET]	=	TAXES DUE
\$675,500	X	[36.12% + 9.71%]	=	TAXES DUE
\$675,500	X	45.83	=	\$309,558

NET AFTER TAXES REGULAR SALE

Gross Cash Close of Escrow	\$690,387
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Less Estimated Taxes Due (\$309,558)

ESTIMATED AFTER TAX NET FROM SALE \$380,829

This \$380,829 will be put into an interest bearing bank account at 7% interest. The taxes due on that interest are assumed in this example to be 32%.

ANNUAL BEFORE TAX NETS
REGULAR SALE & INSTALLMENT SALE

	<u>REGULAR SALE</u>	<u>INSTALLMENT SALE</u>
Income From 7% Bank Account	\$26,658	\$ 14,949
Income From Social Security	\$ 9,600	\$ 9,600
Income From \$400,000 2nd Trust Deed	<u>\$ -0-</u>	<u>\$ 32,000</u>
TOTAL ANNUAL INCOME	<u>\$36,258</u>	<u>\$ 56,549</u>

10 YEAR TOTALS, REGULAR SALE, INSTALLMENT SALE

	<u>REGULAR SALE</u>	<u>INSTALLMENT SALE</u>
Interest from 7% Bank Account	\$ 266,580	\$ 149,490
Income From Social Security	\$ 96,000	\$ 96,000
Income From \$400,000 2nd Trust Deed	\$ -0-	\$ 320,000
Bank Account Balance	\$ 308,829	\$ 213,562
2nd Trust Deed Balance	<u>\$ -0-</u>	<u>\$ 400,000</u>
10 Year Before Tax Totals	<u>\$ 585,009</u>	<u>\$1,092,652</u>

Before taxes, the Installment Sale has netted \$507,643 more, or \$50,764.30 more annually. All of this isn't income, some is principal in bank accounts, the interest from those bank accounts, and a note that is being carried.

This is a before tax look at what you have earned for your client in this situation in 10 years. This is normally what we show him because we don't usually know what their real tax picture will be, and if we do, it is likely to change over the next 10 years because of him and because of still to be written "Revenue Acts." What we want to do now is estimate the income taxes that would be due and calculate that after tax 10 year net.

ESTIMATED 10 YEAR AFTER TAX TOTALS
30.3% MARGINAL INCOME TAX BRACKET USED, WHERE APPLICABLE

REGULAR SALE **INSTALLMENT SALE**

After Tax Income 7% Account	\$ 185,297	\$ 104,590
After Tax Income Social Security	\$ 81,456	\$ 82,980
After Tax Income \$400,000 2nd T.D.	\$ -0-	\$ 213,750
Bank Account Balances	\$ 308,829	\$ 213,562
2nd Trust Deed Balance	\$ -0-	\$ 400,000
Taxes on 2nd Trust Deed (When Paid)	<u>\$ -0-</u>	<u>(\$ 153,855)</u>
10 YEAR AFTER TAX TOTALS	<u>\$ 575,582</u>	<u>\$ 861,027</u>

After Taxes the Installment Sale wins by \$285,445 over the 10 year period, or \$28,544.50 more per year after taxes over the 10 year period. It is important to remember that all of that is not income, some is principal earning income. Now we need to look at the actual income difference in the two situations.

AFTER TAX ANNUAL INCOME
REGULAR SALE AND INSTALLMENT SALE

This is the actual after tax cash that your client would be getting annually, as the principal is tied up in bank accounts and trust deeds.

	<u>REGULAR SALE</u>	<u>INSTALLMENT SALE</u>
After Tax Income 7% Bank Accounts	\$ 18,530	\$ 10,459
After Tax Income Social Security	\$ 8,146	\$ 8,298
After Tax Income \$400,000 2nd T. D.	<u>\$ -0-</u>	<u>\$ 21,375</u>
AFTER TAX ANNUAL INCOME	<u>\$ 26,670</u>	<u>\$ 40,132</u>

The increased annual After Tax Income in the Installment Sale is \$13,462 annually or \$1,121.83 more per month. **Not Bad for Beginners.**

PRINCIPAL CASH REMAINING END OF YEAR 10

	<u>REGULAR SALE</u>	<u>INSTALLMENT SALE</u>
Cash In Bank Accounts	\$ 308,829	\$ 213,562
After Tax Cash Left on 2nd Trust Deed	<u>\$ -0-</u>	<u>\$ 246,145</u>
PRINCIPAL END OF YEAR 10	<u>\$ 308,829</u>	<u>\$ 459,707</u>

You can see from the bank account balances that it is beneficial with the current tax structure to pay taxes in different years, keeping a large part of the gain out of the 39.5% federal bracket and 11% State bracket. All of the additional earning power in the installment sale is due to the unpaid taxes, and the 8% earning ability of your note on your old building. Interesting!!!

THE INSTALLMENT SALE CREATES GREAT VALUE FOR THE CREATIVE BROKER

The Installment Sale is a very usable tool for the creative real estate broker. It is complex unless you are working with it constantly. Always use work sheets to keep you out of trouble. After you have done a few Installment Sales they become quite simple, then if you don't do any for a few months, it's prudent to review before making a fool of yourself, or worse getting yourself into a lawsuit.

CREATING MORE VALUE WITH THE INSTALLMENT SALE, INSTALLMENT SALE EXAMPLE II

Using our 10 unit apartment building as in the last example, we can create value by lowering the down payment and lowering the interest rate on notes carried. This really works, particularly in a hot market.

Suppose the normal rate on trust deeds was 8%, if rates dropped to 6.5% the value of the building would be increased because people like low rates and the building is able to debt service a greater loan with the same payment. It would be easier for the Buyer to qualify with owner carried financing.

Suppose the down payments on a building as in our example is normally 25% of the selling price. If we lower the down payment we will make this building available to more buyers, by sheer virtue of the fact that there are more buyers with less down, in addition, we will increase the buyers leverage. These two moves, lowering the down payment, and lowering the interest rate, while maintaining a positive cash flow, has a "Magical Ability" to create more value.

If we use an All Inclusive Trust Deed, or a Contract of Sale, where the Seller is making the payments on an underlying Trust Deeds and gets the benefits of the equity build up on the underlying trust deeds, we will increase the sellers payoff at the end of the period you have written the loan for. To make this legal, we have to make certain that the buyer has no financial or legal connection with the underlying loan, other than the instrument used for financing this sale, an All Inclusive Trust Deed (A.I.T.D.), or a Contract of Sale.

FORMULATING THE "CREATE VALUE" INSTALLMENT SALE, EXAMPLE II

In this example we will have the Seller carry a \$760,000 All Inclusive Trust Deed at 6% interest only, remember there is an underlying 1st Trust Deed in the amount of \$49,613.04 at 8.5% interest, payable in equal monthly installments of \$615.13 with 120 payments to go, or 10 years, **Fully Amortize**, or payoff the loan. The payments on the All Inclusive Trust Deed will graduate periodically, increase periodically, they will always be interest only, following are the interest payments on the AITD in the respective years.

Year 1 & 2	=	6%	Year 3 & 4	=	7%
Year 5 through 10	=	8%			

This will meet the requirements for the imputed interest rate, currently 9%.

Instead of using a 25% down payment, we will use a 20% down payment, this will cause a great deal more interest for buyers, because of the reduced down payment more people will be able to afford the building. Combining the lower interest rate on the AITD helps make the building more affordable because fewer dollars are necessary to pay the interest on a higher amount. The buildings value is raised 18.75% over what we think the "Fair Market Value" is, additionally, the buyer has no loan points to pay.

**VALUE of BUILDING USING LOWER DOWN PAYMENT
AND LOWER INTEREST RATE, INSTALLMENT SALE II**

Gross Scheduled Income	\$86,400			
Vacancy Factor 5%	(\$ 4,320)			
Gross Operating Income	\$82,080			
Expenses 30%	(\$25,920)			
Net Operating Income	\$56,160			
All Inclusive Trust Deed Payments	<u>(\$45,600)</u>	=	<u>\$760,000</u>	@ 6%
Cash Flow	<u>\$10,560</u>			
Total Loans			\$760,000	
Cash Down Payment 20%			<u>\$190,000</u>	
Selling Price of The Building				<u>\$950,000</u>

NET CASH & PAPER, YEAR OF SALE, INSTALLMENT SALE II

Sales Price of Building	\$950,000
Less Expenses of Sale	(\$ 71,250)
Less All Inclusive Trust Deed	<u>(\$760,000)</u>
NET CASH YEAR OF SALE	<u>\$118,750</u>

**GROSS PAPER, & NET PAPER EQUITY
, YEAR OF SALE, INSTALLMENT SALE II**

All Inclusive Trust Deed	\$760,000
Less Underlying Loans	<u>(\$ 52,637)</u>
NET PAPER EQUITY, YEAR OF SALE	<u>\$707,363</u>

You will want to note at this point that the Seller is getting a payment from the Buyer, then he/she makes the payment on the underlying 1st Trust Deed, he/she also gets the benefit of the equity build up, loan pay down on the 1st Trust Deed. This has the effect of causing the net equity in the AITD to grow.

**FOLLOWING IS A 10 YEAR SUMMARY OF
WHAT WILL OCCUR IN INSTALLMENT SALE II**

<u>Year</u>	<u>AITD Face Value</u>	<u>Underlying 1st T.D. Value</u>	<u>AITD Equity</u>
A.I.T.D. Beginning of investment			\$707,362.92

1.	\$760,000	\$49,613.04	\$710,387.96
2.	\$760,000	\$46,322.36	\$713,677.64
3.	\$760,000	\$42,740.80	\$717,259.20
4.	\$760,000	\$38,842.67	\$721,157.33
5.	\$760,000	\$34,599.99	\$725,400.01
6.	\$760,000	\$29,982.28	\$730,017.72
7.	\$760,000	\$24,956.42	\$735,043.58
8.	\$760,000	\$19,486.29	\$740,513.71
9.	\$760,000	\$13,532.69	\$746,467.31
10.	\$760,000	\$ 7,052.82	\$751,947.18

Notice and remember that using the All Inclusive Trust Deed, or Contract of Sale, where the Seller makes the payments on the underlying loan and gets the Equity Build-Up on that loan, as the underlying loan is paid off the equity in, or the value of, the All Inclusive Trust Deed grows. The Equity Buildup could be given to either the Buyer or the Seller using this type of sale.

Notice from the above that if the AITD was paid off in year one, the net equity would be \$710,387.96 but in year 10 the AITD will have an equity of \$751,947.18, a 10 year growth of \$44,584.26.

**YEAR BY YEAR PAYMENT VALUE AND
RETURN ON \$760,000 ALL INCLUSIVE TRUST DEED INSTALLMENT SALE II**

<u>Year</u>	<u>1st T.D. Payment</u>	<u>AITD Payment</u>	<u>Seller Net</u>	<u>Interest Earned</u>
1.	(\$ 7,381.56)	\$45,600	\$38,218.44	5.83%
2.	(\$ 7,381.56)	\$45,600	\$38,218.44	5.84%
3.	(\$ 7,381.56)	\$53,200	\$45,818.44	6.92%
4.	(\$ 7,381.56)	\$53,200	\$45,818.44	6.93%
5.	(\$ 7,381.56)	\$60,800	\$53,418.44	8.00%
6.	(\$ 7,381.56)	\$60,800	\$53,418.44	8.00%
7.	(\$ 7,381.56)	\$60,800	\$53,418.44	8.01%
8.	(\$ 7,381.56)	\$60,800	\$53,418.44	8.01%
9.	(\$ 7,381.56)	\$60,800	\$53,418.44	8.02%
10.	(\$ 7,381.56)	\$60,800	\$53,418.44	7.89%
TOTALS	\$73,815.60	\$562,400	\$488,584.40	7.20% **
INTEREST	\$37,704.98	\$ 37,704.98	\$488,584.40	**IRR
PRINCIPAL	\$36,110.62	\$ 36,110.62	\$ 44,584.26	7.36%***
FACE VALUE	\$ -0-	\$760,000	\$ -0-	AAPR***

(The Long Term Imputed Rate for November 1993 is 4.83%, we have met and surpassed it.)

LEGALLY AVOIDING MORTGAGE RELIEF

Using the same criteria as the last example, but using a few gyrations to keep the Contract Price up and the Gross Profit Ratio down, we would have the following;

Find the Adjusted Tax Basis

(This Step, finding the Adjusted Tax Basis is Always the Same, in All Calculations)

Original Purchase Price of Building	\$100,000
Plus Acquisition Costs	\$ 1,500
Less Depreciation Taken	(\$ 32,800)
Plus Any Capital Additions	<u>\$ -0-</u>
Adjusted Tax Basis of The Property	<u>\$ 68,700</u>

Step I: Find The Gross Profit

Sales Price of Building	\$950,000
Less Expenses of Sale	(\$ 67,500)
Less Adjusted Tax Basis	<u>(\$ 68,700)</u>
GROSS PROFIT	<u>\$813,800</u>

Step II: Find The Contract Price

Gross Sales Price	\$950,000
Less Encumbrances of Record [If Assumed]*	(\$ -0-)
Plus any Excess of Mortgage Over Basis	<u>\$ -0-</u>
CONTRACT PRICE	<u>\$950,000</u>

* (Notice that not having the buyer assume the loan makes it unnecessary to deduct the loan and has the effect of raising the Contract Price, which has the effect of lowering the Gross Profit Ratio. This lowers the Taxable Gain and the Taxes. IRS disallowed this method about 1982, the courts since have held that IRS had no right to disallow this. This doesn't mean that it is legal, it just means that the court ruled that IRS was beyond the scope of their power. For now use it. On audit it depends???)

Step III: Find the "Gross Profit Ratio"

$$\frac{\text{Net Gain}}{\text{Contract Price}} = \text{Gross Profit Ratio} = \frac{\$813,800}{\$950,000} = 85.66\%$$

[Actual Gross Profit Ratio = 85.6631579%]

Step IV, Establish Taxable Cash in Year of Sale

Gross Down Payment at Purchase (Cash Down)	\$190,000
Plus Net From any Institutional Loans	\$ -0-
Plus any Principal Payments in Year of Sale	\$ -0-
Plus any Excess of Mortgage Over Basis	<u>\$ -0-</u>

CASH RECEIVED FOR TAX PURPOSES, YEAR OF SALE **\$190,000**

FIND TAXABLE CASH YEAR OF SALE INSTALLMENT SALE II

Cash Received	X	Gross Profit Ratio = Taxable Cash Year of Sale
\$190,000	X	85.66% = \$162,754

FIND TAXES DUE, YEAR OF SALE, INSTALLMENT SALE II

Taxable Cash X	Marginal Bracket	=	Taxes Due
\$162,754	X	34.57	= \$56,257

AFTER TAX CASH NET, YEAR OF SALE, INSTALLMENT SALE II

Actual After Sale Cash, Year of Sale	\$118,000
Less Taxes Due	<u>(\$ 56,257)</u>
After Tax Cash, Year of Sale	<u>\$ 61,743</u>

This \$61,743 is placed in a 7% Interest Bearing Account

10 YEAR GROSS FROM INSTALLMENT SALE II

<u>Year</u>	<u>Payment On Note</u>	<u>Interest Bank Account</u>	<u>Totals That Year</u>
1.	\$ 38,218.44	+	\$ 4,322.01 = \$ 42,540.45
2.	\$ 38,218.44	+	\$ 4,322.01 = \$ 42,540.45
3.	\$ 45,818.44	+	\$ 4,322.01 = \$ 50,140.45
4.	\$ 45,818.44	+	\$ 4,322.01 = \$ 50,140.45

5.	\$ 53,418.44	+	\$ 4,322.01	=	\$ 57,740.45
6.	\$ 53,418.44	+	\$ 4,322.01	=	\$ 57,740.45
7.	\$ 53,418.44	+	\$ 4,322.01	=	\$ 57,740.45
8.	\$ 53,418.44	+	\$ 4,322.01	=	\$ 57,740.45
9.	\$ 53,418.44	+	\$ 4,322.01	=	\$ 57,740.45
10.	<u>\$ 53,418.44</u>	+	<u>\$ 4,322.01</u>	=	<u>\$ 57,740.45</u>
TOTALS	<u>\$488,584.40</u>		<u>\$ 43,220.10</u>	=	<u>\$531,804.50</u>

TOTAL EARNINGS, ALL SOURCES
INSTALLMENT SALE II, TIME PERIOD 10 YEARS

Total Earning \$760,000 Note and Bank Account	=	\$ 531,804.50
Less Taxes on Interest Payments 31% Marginal Bracket	=	(\$ 164,859.40)
Payoff, All Inclusive Trust Deed	=	\$ 760,000.00
Payoff, Underlying 1st Trust Deed	=	(\$ 7,052.82)
Balance of Original Cash in Bank Account	=	\$ 61,743.00
Pay Taxes on \$760,000 All Inclusive Trust Deed	=	<u>(\$ 294,130.77)</u>
10 YEAR TOTALS ALL SOURCES	=	<u>\$ 887,504.51</u>

GAIN ON ALL INCLUSIVE TRUST DEED, AT PAYOFF, INSTALLMENT SALE II

Principal Payoff	X	Gross Profit Ratio	=	Gain on AITD Payoff
\$760,000.00	X	84.87%	=	\$645,012

FIND TAXES DUE ON PAYOFF

Principal Payoff	X	Marginal Brackets	=	Taxes Due
\$760,000.00	X	38.70%	=	(\$294,131)

The only thing that we didn't do in Installment Sale II was use the Social Security Income, so we will subtract the after tax Social Security Income from the regular sale, and the 1st installment sale, and make no adjustment to Installment Sale II. This will make the three situations comparable. The after tax income from Social Security was \$81,456 in the Regular Sale and \$82,980 in the 1st Installment Sale.

10 YEAR AFTER TAX NETS COMPARED, THIS WRITING

<u>REGULAR SALE</u>	<u>INSTALLMENT SALE I</u>	<u>INSTALLMENT SALE II</u>
\$575,582	\$861,027	\$ 857,164
<u>(\$ 81,456)*</u>	<u>(\$ 82,980)*</u>	<u>\$ None</u>
<u>\$494,126</u>	<u>\$778,047</u>	<u>\$ 857,164</u>

* Less After Tax Social Security Income, Regular Sale, and Installment Sale I