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MONETIZED INSTALLMENT SALE "VS" 1031 TAX DEFERRED EXCHANGES

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Monetized Installment Sales vs. 1031 Tax Deferred Exchanges

1031 tax deferred exchanges are not the only way to defer taxes on the sale of a real estate investment when the intent is to acquire another real estate investment with the sale proceeds. A structured sale known as a Monetized Installment Sale exists that can offer real estate investors an alternative real estate replacement technique that defers tax, involves substantially less risk of failure to defer tax than a 1031 exchange, and removes any temptation to overpay or compromise on property standards when selecting and bidding on replacement properties. These advantages should persuade real estate investors to seriously consider this option.

The widely known and utilized 1031 exchange is the standard method of disposing of and reinvesting in appreciated real estate. When successful, a 1031 exchange defers capital gains tax on sale. Exchanges often succeed, but they sometimes either fail or, if they don't fail, result in sub-optimal replacement property investments, either due to overpaying for replacement property or accepting a substandard replacement property.

These outcomes can occur due to the rigid rules governing 1031 exchanges. Exchange rules may hinder 1031 exchange participants when negotiating to buy a replacement property primarily because they must transact within a short, specific time frame to avoid losing the tax deferral on their relinquished property. The effect of diminished negotiating power possessed by 1031 participants, due to IRS deadlines, can be a significant hidden cost of 1031 exchanges.

In addition, 1031 exchanges impose many other constraints that are not present when using monetized installment sales, unnecessarily limiting the exchange participant's choice of replacement properties and freedom to transact.

Monetized Installment Sales – Cashing Out While Deferring Tax

A monetized installment sale can be used to sell real estate, defer the capital gains tax for 30 years and obtain a high percentage of the net sales proceeds in cash. The cash then may be used, if desired, to invest in a replacement property, and without any deadlines. As such, a monetized installment sale is an alternative to a 1031 exchange.

The Monetized Installment Sale is a way of structuring the sale of an appreciated asset with a low cost basis relative to its sales price so that capital gains tax otherwise triggered by the sale of the asset is deferred and a high fraction of the sales proceeds may be obtained in cash at closing. The strategy pairs a tax-deferred installment sale of the asset with a "monetization loan" that, in effect converts installment payments received by a seller over time into a single lump-sum of cash that the seller may invest as they please.

The asset is sold to the buyer through a dealer so that the seller does not have a continuing relationship with the buyer. The ongoing installment payments received from the seller from the dealer are matched by payments made to the monetization loan provider, so the seller's only net cash flows are the cash received at closing and the capital gain tax due in 30 years.

More than Just a 1031 Backup Plan

Those who are familiar with both 1031 exchanges and monetized installment sales tend to think of monetized installment sales as a good alternative to employ for 1031 exchanges that are about to fail. Rather than accepting capital gains tax liability, the participant in a failing 1031 exchange may convert their exchange to a monetized installment sale and use the cash received at closing to acquire a replacement property. In this case, the would-be exchange participant is freed from 1031 exchange requirements, with no imposed deadlines, and may shop for their next investment without any time pressure. At the same time, they can defer their capital gains tax. The only difference in the tax deferral is that with the monetized installment sale the deferral is usually for 30 years, while with an exchange the deferral is indefinite and ends upon the cash sale of a replacement property.

Monetized installment sales are perceived as being costlier to the participant than a 1031 exchange. Other than the fact that monetized installment sales are relatively unknown, the up-front cost is the primary reason they are seldom used as the primary means by which to move out of one real estate investment into another. The monetized installment sale participant nets 93.5% of the sales proceeds of the property they are selling, compared to 100% for the 1031 exchange participant. Although the 6.5% reduction in proceeds is not actually a fee, nonetheless it exists and must be considered. This fact alone can dampen interest in the idea of a monetized installment sale.

That is unfortunate because a fuller understanding of the differences between exchanges and monetized installment sales would lead many would-be exchangers to seriously consider a monetized installment sale as their preferred tax-deferred sale and replacement strategy. After all risks and after-tax cash flows involving both the relinquished and replacement properties are considered, the monetized installment sale can be more tax-efficient and lower risk than an exchange when selling and reinvesting in real estate.

Differences Between 1031 Exchanges and Monetized Installment Sales

In comparing a 1031 tax deferred exchange to a monetized installment sale, a wide variety of factors, including exchange deadlines, come into play. These are two very different strategies for obtaining deferral of capital gains tax.

Asset Type Limitations: One difference is that, while a 1031 exchange is confined to the exchange of real property, a monetized installment sale may be applied to most asset types, including real property, businesses, intellectual property, etc. Only publicly traded securities are excluded.

Timing Flexibility and Liquidity: Additionally, the specific goal of a 1031 exchange is to quickly exchange one relatively illiquid asset for another (real estate), typically higher in value, without triggering capital gains tax on the disposition of the relinquished property. With a monetized installment sale, the end goal may be the same, but in practice the immediate goal usually is to exit from one investment, which may or may not be real property, and receive cash, which may or may not be reinvested in real estate. The monetized installment sale, then, is more versatile in its applications because of the wide range of asset types it accommodates, the timing flexibility it offers, and the liquidity it produces.

Risk of Breaking Rules and Having to Pay Tax

Successful completion of a 1031 exchange requires strict adherence to many IRS rules. Failure to comply with any of these rules will result in failure of the exchange and triggering of capital gains tax. Ten of these 1031 exchange rules are listed below, none of which apply if the monetized installment sale is used. The only rule common to both strategies is that the redeployed capital be used for investment purposes. However, with an exchange this is further defined via several rules as “like kind real estate.” The monetized installment sale provides completely unfettered access to and reinvestment of funds.

Other Exchange Rules to Observe –or Bypass

In addition to the deadlines mentioned above, there are numerous other rules and restrictions that 1031 exchange participants must follow to defer capital gains tax, none of which apply to or have any impact on monetized installment sale participants:

Exchange rules concerning the relinquished property:
1. Choice of replacement property is limited by:

- the three-property identification rule; or
- the 200% property identification rule; or
- the 95% property identification rule.

2. Relinquished property must have been held for investment purposes (for a period that has not been defined by law or regulation, creating legal uncertainty).

3. All cash from the sale must be applied to the purchase of replacement property.

4. One cannot exchange a primary residence or vacation property without first converting it to investment purpose (conventional wisdom suggests renting it out for 2 years).

Exchange rules concerning the replacement property:

5. Exchanged properties must be "like kind" (i.e. real property for real property).

6. An exchange of depreciable property for non-depreciable (land) is not allowed.

7. There must be common ownership between relinquished and replacement property.

8. The replacement property cost must be greater than or equal to the sale price of the relinquished property.

9. The amount of debt on the replacement property must be equal to or greater than the debt on the relinquished property.

10. One must hold the replacement property for enough time before reselling to demonstrate investment intent.

None of these ten exchange rules and restrictions apply when deferring tax and reinvesting in real estate via a monetized installment sale.

Why 1031 Participants are Likely to Pay a Premium

Complying with 1031 exchange deadlines can be costly. The rules governing 1031 exchanges fundamentally alter the parameters surrounding the decision to buy a replacement property. Compliance with these rules compromises the buyer's negotiating power and leads to payment of higher prices for replacement property than paid by non-1031 exchange participants.

In addition to the primary goal of finding a replacement property that will meet the exchange participant's investment criteria, exchange participants also must meet potentially severe time constraints to attain their secondary goal of preserving their tax deferral. The 1031 exchange participants must identify a replacement property within 45 days of the sale of the relinquished property and must close on that property within 180 days. The time pressures associated with these deadlines may be magnified when markets are thin and suitable replacement properties are hard to find, even for non-exchange buyers. The replacement property buyer's relative urgency and lack of time to search the market and perform due diligence impairs their bargaining power.

Compliance with Sec. 1031 includes other rules, such as buying a replacement property equal or greater in value and maintaining at least as much debt on the replacement property as was held on the relinquished property, to name a few. Other obstacles a replacement property buyer may encounter include the possible need for permits, appraisals, loan approvals, inspections, and licenses. They also are reliant upon the competence and willingness of the seller. All these factors are beyond the control of the replacement buyer and can complicate the purchase decision, narrow choice, reduce the chances of complying with Sec. 1031 in a timely fashion, and generally impair the exchange participant's negotiating position.

Some of these obstacles can be avoided by conscientious identification of the replacement property before disposal of the relinquished property. Also, it may be possible to make the closing of the 1031 exchange contingent upon finding a suitable "like kind" property within the mandated time, thus removing any need for urgency, although market pressures may inhibit this tactic in practice. Buyers who are willing to include out of state replacement property candidates in their searches also may improve the odds that their exchanges will succeed, but there is evidence that out-of-state buyers end up paying price premiums, as noted in Table 1, below.

How Much More a 1031 Exchanges Costs –All In

With the added incentive of compliance in mind, economic logic suggests that 1031 exchange buyers are more likely to pay a premium for replacement property, which can substantially boost the relative cost of undertaking a 1031 exchange. 1031 exchange replacement property buyers can be expected to pay a premium because they have more at stake (their capital gains tax deferral) than non-exchange buyers, which can alter the way exchange buyers' value potential investments. Exchange buyers may count anticipated tax benefits as an offset to the market price of the replacement property, which means they may be willing to pay more than regular buyers.

There is plenty of evidence to support this idea. Numerous studies have shown that 1031 buyers of replacement properties tend to pay more than non-1031 exchange buyers for the same property. Exchange buyers frequently overpay even more than the value of their tax deferral. One of the most highly cited studies (Ling and Petrova, 2008) came to this conclusion:

> *"Thus, for many investors the pursuit of tax avoidance [using a 1031 exchange] comes at a steep price. The magnitude of the empirical price premiums varies from 15% to 35% across markets and far exceed estimates of the value of tax-deferral obtained via an exchange, especially if the exchanger expects to hold the replacement property for a relatively short period of time. Thus, it appears that many...market investors are paying price premiums that may offset, in whole or in part, the gain from the deferment of taxes. For these investors, the pursuit of tax avoidance comes at a steep price."*

In a subsequent study of over 100,000 transactions by the same researchers (2010) they observed a 12.5% premium paid when purchasing smaller properties, with a range of seven percent to 20 percent:

> *"...tax-motivated buyers seeking to complete a delayed Section 1031 exchange pay average price premiums that range from approximately seven percent to 20 percent when purchasing properties with acquisition prices less than $3.77 million, which is the mean transaction price in our sample. This result is consistent with our expectations that the time constraints associated with the successful completion of a delayed exchange increase the search costs, and therefore the reservation prices, of taxpayers seeking to complete a delayed exchange."6*

Their findings are not an aberration. As illustrated in Table 1 below, other studies have revealed that replacement property buyers have paid from 4% to 35% more than non-exchange buyers for the same property.

Table 1

Replacement Property Price Premiums Paid by 1031 Exchange Participants

Researcher	Year	Property Type	Market	Premium
Holmes and Slade[1]	2001	Office	Phoenix	7.9%
Lambson, McQueen, and Slade[2]	2004	Apartments	National	4.0%
Petrova[3]	2006	Apartments	National	10.5%
Petrova[3]	2006	Office	National	28.3%
Petrova[3]	2006	Retail	National	26.1%
Petrova[3]	2006	Apartments	Out of state	16.7%
Petrova[3]	2006	Office	Out of state	23.5%
Petrova[3]	2006	Retail	Out of state	28.3%
Johnson and Wiley[4]	2008	Office	National	$71.84 per sq. ft.
Ling and Petrova[5]	2008	All	National	5% - 35% (9% avg.)
Ling and Petrova[5]	2008	Apartments	National	9.0%
Ling and Petrova[5]	2008	Commercial	National	25.0%
Ling and Petrova[6]	2010	Small	National	12.5%
Dillard et al[7]	2013	Farm	Indiana	10.0%

Ling and Petrova's work in 2008 showed that the price premiums vary considerably by local market and asset type. For example, the average premium paid for apartments in Seattle was 4.8% while in Denver it topped 20%. For office properties, the average low was surprisingly high (14.8% in Seattle) while the highest average office price premiums seen were in Tampa, at 35.2%. Figures1 and 2, below, illustrate these findings.

Monetized Installment Sales vs. 1031 Tax Deferred Exchanges

Figure 1

Average Premium Paid for Apartment Buildings
By 1031 Exchange Replacement Property Buyers

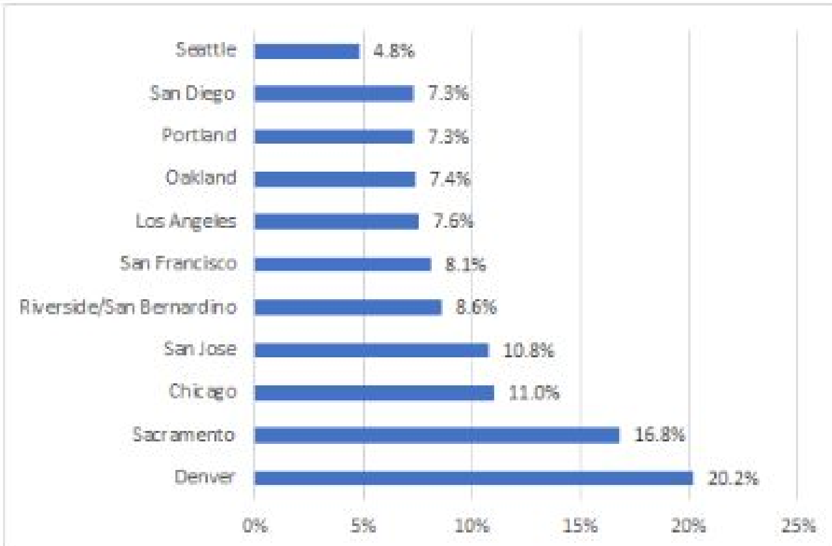
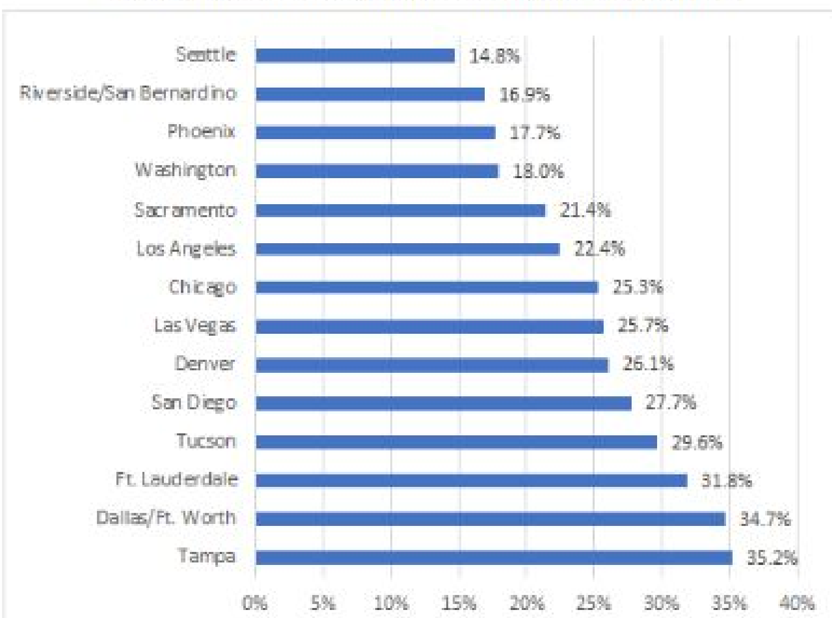


Figure 2

Average Premium Paid for Office Buildings
By 1031 Exchange Replacement Property Buyers



Source: Ling, David C, and Milena Petrova. 2008. "Avoiding Taxes at Any Cost: The Economics of Tax-Deferred Real Estate Exchanges." The Journal of Real Estate Finance and Economics 36(4):367-404

Monetized Installment Sales vs. 1031 Tax Deferred Exchanges

Whenever a 1031 exchange participant is unable to comply with Sec. 1031 deadlines, they will owe capital gains tax. The risk of a failed 1031 exchange is so large and well-known that private enterprise intermediaries have arisen within the market to provide packaged, passive real estate investments priced at a premium. The providers of these investments profit by repackaging corporate owned real estate and selling it to risk-averse 1031 exchange replacement property buyers.

The tendency for anticipated tax deferral to influence real estate pricing decisions also may be present when exchange participants sell their relinquished properties, because they can include the value of their anticipated tax deferral when considering what prices to accept from bidders.

More Freedom and Less Risk with a Monetized Installment Sale

In contrast, the monetized installment sale imposes no property identification deadline. Property sellers using this option are under no pressure to overpay or accept substandard replacement properties when they are ready to redeploy the proceeds of their sales.

Similarly, the monetized installment sale has no 180-day closing deadline. Exchange participants, however, are given six months from the time their relinquished properties close, to then close on previously identified replacement properties. Many potential pitfalls could undermine that outcome, such as the discovery of property defects or problems securing financing. Failure to close on time, or at all, will result in payment of capital gains tax. ***This risk does not exist when using a monetized installment sale as the tax deferral strategy.***

To summarize, a 1031 exchange entails risks that are not present when using a monetized installment sale to dispose of real property and subsequently reinvest in real property. These exchange risks include:

- Risk of failure to meet strict deadlines, resulting in immediate tax liability.
- 2. Risk of compromising on investment standards or overpaying for replacement property to meet deadlines and preserve tax deferral.

The cost of overpaying for a replacement property in an exchange can easily outweigh the 6.5% reduction in net sales proceeds involved with a monetized installment sale, as previously mentioned. Likewise, considering the potential reduction in ROI if, to complete an exchange, the participant accepts a substandard property, a monetized installment sale can be a better option because it eliminates this possible risk.

Exchange Carryover Basis is a Lost Depreciation Opportunity

In addition, an exchange requires the participant to continue depreciating their deferred capital gain as "carryover basis," using its pre-existing depreciation system. In contrast, a monetized installment sale would provide a completely new cost basis for the replacement property. With an entirely new cost basis, the monetized installment sale enables the investor to get more depreciation deductions, faster. Under the Tax Reform and Jobs Act of 2017, the monetized installment sale participant who sells and reinvests in real estate would be able to apply cost segregation to write off a sizable portion of their investment in the year of acquisition, using the new 100% bonus depreciation option. The amount of this attractive deduction would be lessened in an exchange scenario due to the inability to cost-segregate carryover basis without triggering capital gains tax. The impact of this phenomenon can easily offset the initial cost of the monetized installment sale. See the Appendix for a numerical illustration of this effect.

Summary

A 1031 exchange appears to be an ideal strategy, when it works, and it reveals itself to be a cause for dissatisfaction when it fails to live up to its expectations. When exchanges work, it is likely because inventory in real estate markets is plentiful, so the exchange deadlines for identifying and closing on the replacement property may be more easily met. This is not always the case. Even under ideal conditions, the risk that an exchange might fail is never zero. Many factors beyond the exchange participant's control can easily derail their plans. If the exchange fails, tax is due. If the exchange completes, but requires the participant to overpay for, (or to accept a less-than-adequate) replacement property to ensure deferral of gain, the outcome cannot be considered successful.

Considering the many things that must go "right" to result in a satisfactory outcome, it's worth looking at the monetized installment sale as a way to sell and reinvest in real estate without the risks inherent in 1031 exchanges. The monetized installment sale is a strategy that puts the timing and terms of disposition of property and subsequent reinvestment completely under the seller's control. Although the net proceeds obtained from the sale of the relinquished property are lower than with a 1031 exchange, the monetized installment sale participant enjoys complete freedom to invest in a replacement property without the stress caused by 1031 exchange rules. Therefore, there is no motivation to overpay or compromise on investment criteria. Without carryover basis, depreciation deductions on the replacement property are maximized. As well, with a monetized installment sale the risk that the tax deferral may be lost due to the transaction collapsing is zero.

Further, the flexibility offered by the monetized installment sale does not limit the range of reinvestment to the same asset class (real property) but instead allows the investor to redeploy the cash sales proceeds in any manner they choose, including real estate, stocks, bonds, a business, a mix of the foregoing options, or sitting on cash for as long as they like, until the right investment is found.

The monetized installment sale participant can transact without guesswork about its outcome, which is not true for the 1031 exchange participant. Unlike the monetized installment sale participant, the question the 1031 exchange participant should be asking themselves is "Do I feel lucky?

References

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Appendix

Under a reasonable set of assumptions, a monetized installment sale can produce a nearly identical after-tax cash flow impact compared to a 1031 exchange, considering both the 6.5% reduction in net sales proceeds with the monetized installment sale and the offsetting tax benefit of additional bonus depreciation available on the replacement property. The results are sensitive to the amount of accumulated depreciation taken on the relinquished property and the assumptions made about the characteristics of the replacement property that affect cost segregation and bonus depreciation results.

Monetized Installment Sale Adjustment

Sales price	$ 5,000,000	The monetization loan amount is 95% of the net sales proceeds and includes approximately 1.5% in transaction costs, which themselves are income tax-deductible.
Selling costs %	5%	
Selling costs	250,000	
Net sales proceeds	4,750,000	
MIS adjustment %	6.50%	
MIS adjustment	308,750	
Deductible portion of MIS adjustment (1.5%)	71,250	
Income tax rate	40%	
Tax deduction	28,500	
After-tax MIS adjustment	**280,250**	

Accumulated Depreciation*

Acquisition cost	1,500,000	Accumulated depreciation assumptions are made for the relinquished property as they are subsequently needed for the computation of capital gain, below.
Land cost	375,000	
Depreciable basis	1,125,000	
Depreciation life	39	
Annual straight-line depreciation	28,846	
Years held	25	
Accumulated depreciation	721,154	

*Assumes no capital improvements post-acquisition and no accelerated depreciation.

Adjusted Cost Basis

Purchase price	1,500,000	Adjusted cost basis, needed for capital gain calculation below, is based on assumptions for original purchase conditions, less depreciation taken, from above.
PLUS: Acquisition Costs	75,000	
PLUS: Capital improvements	-	
LESS: Depreciation taken during ownership	721,154	
EQUALS: Adjusted basis at time of exchange	853,846	

Capital Gain

Net sales proceeds	4,750,000	Capital gains tax requires an assumption about the taxpayer's federal and state capital gains tax rate. The tax is deferred but also affects the amount of carryover basis, below.
Less adjusted cost basis	853,846	
Capital gain	3,896,154	
Capital gains tax rate	30.00%	
Deferred capital gains tax	1,168,846	

Additional Bonus Depreciation Tax Benefit

	Carryover basis (deferred capital gain)	3,896,154	The monetized installment sale participant is able to cost-segregate all of their depreciable basis in their replacement property. The exchange participant's carryover basis does not enjoy this option, so the difference in tax benefit is an added cash benefit in year 1 for the monetized installment sale participant.
x	Improvement percentage	75%	
=	Carryover basis in improvements	2,922,115	
x	Percentage of bonus eligible assets	24%	
=	Bonus depreciation amount lost	701,308	
x	Income tax rate	40%	
=	**Additional bonus depreciation tax benefit**	**280,523**	

Net advantage over 1031 exchange $ 273