Creating Large Pools of Assets to Manage: A Planning Tool for Deferring Taxes for up to 20 Years

If your client or prospect is selling a highly appreciated business or real estate, it can provide them with a wonderful and satisfying experience. They are seeing the seeds they planted grow into the valuable enterprise that it is today.

Our experience tells us that considering a planning tool known as an ***Intermediated Installment Sale*** could provide a number of overlooked benefits, which could be helpful while selling highly appreciated assets.

An ***Intermediated Installment Sale*** is an alternative to an outright sale which uses IRS Code §453 as its foundation. Known as an ***Installment Sale,*** *it* provides a number of benefits when compared to an outright sale.

· Eliminates the risk associated with "carrying a note" for a buyer

· Can provide asset protection against creditors and lawsuits

· Replaces income lost when selling a business or real estate

· Provides capital gains deferral for up to 20 years

· Allows you to use inflation to your advantage

· This planning tool can potentially provide more investable cash and more income

At its core, an ***Intermediated Installment Sale*** spreads the income from the sale over the life of the installment note. In some circumstances, spreading the capital gains over multiple years can provide financial benefits compared to reporting the entire gain in one year.

An ***Intermediated Installment Sale*** follows a somewhat simple process:

· Your client or prospect decides to sell their business or real estate

· They negotiate the sale with their buyer and their buyer arranges their financing for the purchase and they go to contract

· Expert legal counsel prepares an ***Intermediated Installment Sales*** Trust naming an Independent Trustee to administer the trust. This is the vehicle for the transaction.

· The independent trustee buys the asset for the price and the terms negotiated with the buyer, delivering a promissory note to your client. The trust is now your client's debtor.

· The independent trustee sells the asset to the buyer and places the proceeds into an irrevocable trust and the independent trustee administers the trust.

· As their financial advisor, **you manage these assets,** replacing income that may be lost by the sale of the business or real estate

Let us explore a hypothetical case study and assume the following:

· Your client or prospect intends to sell an asset in California.

· They own 100% of the asset.

· The asset is valued at $5,000,000.

· Their cost basis is $500,000.

· There is no third party debt, such as a mortgage or business loan.

· For this hypothetical illustration, the applicable capital gains tax rates are:

- Federal tax rate of 20%.

- State effective tax rate of 12.93%.

- Medicare tax rate of 3.8%.[1]

- There may be other state or local sale or transfer taxes that apply at the time of sale; these are not itemized here for purposes of this hypothetical example.

Based on our hypothetical case study, if you sell the business outright for $5 million and your cost basis is $500,000, your taxable gain is $4.5 million. Therefore, at sale, estimated capital gains taxes due will be:

Federal Tax	$900,000
Medicare Tax (if applicable)	$171,000
State Tax	$581,850
Total Tax Due	**$1,652,850**
Total Net After Taxes	**$3,347,150**

Instead of an outright sale, you can sell the asset in a carefully constructed ***Intermediated Installment Sale***. Since you defer taxes in the ***Intermediated Installment Sale***, you would begin with the full $5 million invested as opposed to the after tax amount of $3,347,333 in the outright sale.

The money in the trust from the completion of the Intermediated Installment Sale allows the trust to enjoy the "earning power" of the $1,652,567 that would have been immediately paid in taxes under the outright sale.

This can potentially provide more investable cash and more income.

Below is a hypothetical illustration comparing an ***Intermediated Installment Sale*** to an outright sale of the asset. In the calculations, we assume a sale price of $5,000,000 with a cost basis of $500,000, as per the above hypothetical case study.

This illustration assumes the same post sales income tax on the investment income and same advisory fees but provides the net return on the trust after trust administration fees. We are assuming a 10-year note with an option taken for an additional five years for a total of 15 years. We are assuming this note is interest only with a balloon at the end of the 15 years, at which point, the tax on the sale of the asset is due.

	Outright Sale	Intermed Installmen
Cash available to invest	$3,347,150	$5,0
Hypothetical annual Income @ 6.5% (2)	$217,564	$3
Accumulated income over 15 years	$3,263,460	$4,5
Taxes Due after year 15		$1,6
Total Economic Value after 15 years	$6,610,610	$7,8

In this hypothetical case study, the ***Intermediated Installment Sales*** potentially provides a total of $1,228,091 of additional income and economic value during the 15-year period.

In addition, if we assume a 2% rate of inflation, the present value of the tax due today of $1,652,850 paid 15 years from now, would be $1,228,091 or 74.3 cents on the dollar, thereby putting inflation to work for your client!

In our view, the ***Intermediated Installment Sale*** provides significant advantages to an outright sale – advantages many times over looked when transitioning ownership of a business or real estate.

At the same time, it creates a large pool of assets for you to manage.

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[1] The Medicare tax may not be applicable depending on the sale structure. For this illustration, it is included.

[2] Net return on the Intermediated Instalment sales is 6% due to trust’s 50 bps annual administration fee.