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Installment sale surprise

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Sellers of commercial real estate often attempt to make a real property more attractive to potential buyers by offering seller financing with respect to all or a portion of the sale price. From a buyer's perspective, the terms and conditions, including interest rate, amortization and term, may be more favorable than a potential buyer could obtain from an institutional lender. Thus, the real property may attract more interest.

In addition to marketing benefits, seller financing may offer other benefits to the seller. From a federal income tax perspective, a sale which provides that all or a portion of the sale's proceeds are deferred, may provide tax benefits as an installment sale. Generally, a seller of real estate that is not a dealer with regard to the real estate being disposed of may qualify for deferral of gain recognition. In fact, installment sale reporting may be required unless the seller affirmatively elects out of such reporting. Pursuant to the installment sale method, the seller reports a pro rata share of the gain recognized as payments are received from the buyer. As an aside, the deferred payments must provide for interest or the Internal Revenue Service will impute interest.

Sellers must be aware, however, that the installment sale gain recognition deferral is not available to the extent of depreciation recapture. Gain must be recognized by the seller in the year of sale to the full extent of the previously available depreciation deductions. This depreciation recapture is mandatory even if the buyer makes no payments in the year of sale. Sellers must be sure to consider this depreciation recapture in evaluating the marketing and sale of a real property.

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