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Customized Deal Structures for Garage Owners

By James R. Goldman

Owners of parking garages are often reluctant to sell their properties because of concerns about the federal and state income taxes that result from the sale. However, owners should be aware of the wide variety of alternative deal structures available that enable willing buyers and sellers to control the timing of the recognition and payment of income taxes.

Under the Internal Revenue Code of 1986, as amended (the "Code"), taxpayers generally do not recognize taxable income unless and until they receive payment for the property conveyed. As a result, the timing of income tax payments may be controlled through careful planning as to when payments are received. In addition, the characterization of the payments received can affect the recognition of taxable income.

The Conventional Transaction

Generally, the sale of a parking garage can be accomplished through the transfer of title to the property, together with any related personal property, in exchange for a combination of cash and assumed indebtedness. The attraction of this transactional structure is clear—certainty of result in which the seller receives 100% of the proceeds from the sale at closing and is fully released from all the risks of ownership.

Of course, the certainty of result has both benefits and detriments. The benefit is that the seller will receive the full amount of the consideration from the sale of his or her property at closing, with no future risk related to collecting any portion of such consideration or the future operating results of the property. The detriment is that the seller will recognize the full amount of any taxable income, and pay the tax related thereto with the seller's tax return for the tax year in which the transaction occurred.

Typically, the gain on the sale of a parking garage will result in capital gain subject to the recapture of any depreciation (at a 25% tax rate) pursuant to Sections 1245 and 1250 of the Code. However, with today's long-term capital gain rate at 15%—the lowest that it has been and may be for many years—the current recognition of capital gains may be very attractive. A seller must also address estate tax planning issues in which the seller doesn't want to pay both capital gains tax and estate tax. Additionally, in cases where the property has been refinanced one or more times, a sale for cash and assumed indebtedness may result in a tax obligation greater than the net proceeds generated from the sale.

An illustration of the foregoing tax results may be useful. Assume, for example, that a seller ("Seller X") has a 100% interest in Green City Parking Garage, a 400-space parking garage worth $10,000,000, subject to a first mortgage of $6,000,000, and an adjusted tax basis of $3,000,000. If Seller X conveys Green City for a combination of $4,000,000 in cash and assumed debt of $6,000,000, then Seller X will generate a taxable gain of $7,000,000, which generally

will be subject to tax at the current capital gains tax rate of 15%, plus any recapture, generally taxable at 25%. Assuming no recapture, Seller X's current tax obligation under this example would be $1,050,000, and Seller X would have received after-tax cash of $2,950,000.

Tax Deferred Transactions

When a parking garage owner wants to sell his or her property and defer the current recognition of taxable gain and taxes, there are several ways to accomplish this objective. The most commonly used tax deferral techniques are:

- Tax-free exchanges.
- Installment sales.
- Contribution to a partnership or limited liability company.
- Lease with option to buy.
- Loan with option to buy.

The following examines each of these techniques and demonstrates their application through use of the Green City Parking Garage example mentioned above.

Tax Free Exchanges

Perhaps the most effective technique, and certainly one of the most popular, for deferring the recognition of taxable gain and the payment of taxes until a future date is through "tax-free exchanges," as defined pursuant to Section 1031 of the Code. Section 1031 allows a real estate owner to exchange the owner's property for "like-kind" property without any current recognition of a taxable event. Under a "like-kind" exchange, all of the tax characteristics of the old property (tax basis, potential recapture, etc.) are transferred into the new property; therefore, when the new property is sold, the gain on the old property and the new property is recognized, and the tax is paid at that time.

This method is widely used by property owners today who wish to reduce their involvement with, and risk from, existing real estate investments while remaining invested in real estate. For instance, an "active" owner of a parking garage may seek to exchange his or her interest in the garage for a "passive" investment in a retail/industrial "triple-net leased" property (e.g., a free-standing retail building leased to a national drug store company).

In the Green City example, suppose Seller X has decided to exchange his or her interest in Green City for a triple-net leased property. At closing, Seller X exchanges title to Green City for the title to the net leased property, with no other cash payments being made. At this point, Seller X's basis in the net leased property will be the same $3,000,000 basis that Seller X had in Green City, as long as the net leased property has at least $6,000,000 of debt on it at the time of the exchange. If Seller X were to sell the net leased property the following day, Seller X's taxable gain and tax would be identical to that which Seller X would have had through the sale of Green City.

Installment Sales

The most commonly used technique to defer the recognition of taxable gain and the payment of taxes is through the installment sales method. An installment sale is accomplished by deferring the receipt of a portion of the proceeds from a taxable sale into the future (i.e., one or more tax years beyond the current tax year). This allows the recognition of the gain for tax purposes to be spread out over the period that future payments will be received. (Note, however,

The most commonly used technique to defer the recognition of taxable gain and the payment of taxes is through the installment sales method. In this manner, a seller can time the recognition of taxable gains to coincide with taxable losses generated on other activities and, therefore, reduce his or her overall tax burden.

that there are several significant exceptions to this rule, including the requirement that a seller recognizes any depreciation recapture at the time of sale and the limitations related to "qualified indebtedness." Consult your personal tax advisor for application of these and other relevant exceptions.)

From the earlier Green City example, assume that instead of receiving $4,000,000 of cash in the current year, Seller X elects to receive $1,000,000 per year, with the first payment being received at closing. Seller X will still realize a taxable gain of $7,000,000 on the sale of Green City (gross proceeds of $10,000,000, less adjusted basis of $3,000,000), but Seller X will only recognize and be taxed on a gain to the extent that Seller X has received the proceeds of the sale.

In this example, Seller X will: receive 25% of the gross cash proceeds ($1,000,000) from the sale of Green City at closing; recognize 25% of the taxable gain ($1,750,000); and pay capital gains tax ($262,500), subject to any Section 1245/1250 recapture, for the tax year in which the sale occurred. In succeeding years, Seller X will recognize the percentage of taxable gain that corresponds to the percentage of gross receipts received and pay capital gains taxes (subject to any Section 1245/1250 recapture) on such amounts.

Installment sales provide a seller with control over the timing of taxable gains. In this manner, a seller can time the recognition of taxable gains to coincide with taxable losses generated on other activities and, therefore, reduce the seller's overall tax burden.

Contribution to a Partnership or LLC

A seller's contribution of a property to a partnership or limited liability company (that has elected to be treated for tax purposes as a partnership) is another popular technique for deferring the recognition of gain and payment of income taxes. Often referred to as an UPREIT or DOWNREIT transaction—a result of the popularity of this technique among public and private REITs—this approach involves the contribution of a property to a partnership or LLC for either regular or preferred interests in a partnership or LLC. As long as certain conditions are met, the contribution of the property to the partnership or LLC for the units is tax-free, and the tax basis of the property becomes the seller's tax basis in the units. If the contribution is properly structured, no taxable gain will be recognized and no tax will be paid until the units are sold.

This method is useful when the seller wants to reinvest the proceeds from the sale of a property back into real estate. The principal difference between this method and the tax-free exchange is that, if the partnership or LLC owns more than one property, the reinvestment will be into a diverse pool of real estate properties. Also, even though these types of transactions are often referred to as UPREIT and DOWNREIT transactions, they can be accomplished with any partnership or LLC.

Returning again to the Green City example, suppose Seller X wants to diversify the risk of owning a single property, but wants to remain invested in real estate. Of course, Seller X wants to accomplish this without paying any income taxes. Seller X may contribute Green City, subject to its existing

Income Tax Planning

General principles of income taxation:

- Property owners do not recognize a taxable gain or loss on a property until the occurrence of a realization event.
- Realization occurs when the taxpayer conveys the benefits and burdens of ownership of the property.
- Generally, a taxable gain is not recognized until cash is received.

indebtedness, to a partnership that already owns 19 parking garages in exchange for a negotiated interest in a partnership that reflects the net relative value of Green City and the partnership's other assets. Assuming that each of these garages was worth exactly the same amount as Green City, Seller X's interest in the partnership—1/20—would equal his or her equity in Green City. But now, Seller X may look to 20 properties to produce the returns that Seller X formerly had earned from Green City, and rely upon the partnership's management team to manage and create value at Green City, and throughout the partnership's portfolio. This would all be done without the recognition of a taxable event; if structured properly, Seller X would only recognize a taxable gain and pay taxes if Seller X sold all or part of his or her interest in the partnership.

There are two additional benefits of this technique: First, in conjunction with Seller X's contribution of Green City to the partnership, Seller X may agree to reduce his or her participation in the future growth of Green City and the partnership's other real estate assets in exchange for reduced risk through the receipt of a preferred interest in the partnership (which would produce a yield on Seller X's investment that would be paid prior to other investors); second, the ownership of partnership interests, in lieu of a direct interest in real estate, may facilitate estate tax planning strategies, particularly an annual gifting program.

Lease with Option to Buy

Sometimes, the ultimate sale of a parking garage may be accomplished more efficiently through two steps instead of one. For instance, if a seller wants to receive some cash immediately but defer the recognition of a taxable gain until a later date, this may be accomplished through the combination of a lease with an option to buy. Through this technique, the seller leases the property to the buyer for a number of years, and sells the buyer an option to purchase the property for a period of time to begin some years later at a fixed price. During the term of the lease, the seller will recognize ordinary income from the lease payments, but will still be entitled to deduct depreciation expense on the property.

If structured properly, the lease deposit and the option payment the seller receives will not be taxed until the lease deposit is applied pursuant to the lease, and the option either is exercised or expires. This technique gives the seller some cash immediately (without the recognition of taxable income and the payment of taxes), and also transfers some, but not all, of the risks and rewards of owning and operating the property to the buyer.

To illustrate this technique using the Green City example, assume that Seller X wishes to avoid recognizing any significant taxable gains for at least 10 years. Seller X may agree to lease Green City to a buyer ("Buyer Y") for 10 years, giving Buyer Y many of the benefits and burdens of ownership, combined with an option to purchase Green City for $12,000,000 in the last year of the lease. Seller X's receipt of lease payments will produce current income that will be offset substantially by Seller X's continuing depreciation of Green City.

Additionally, the security deposit for the lease—equal to approximately one year's lease payment—would be received tax deferred, and the amount paid for the option—equal to several percent of the gross price of the property—would be received tax deferred until the option is exercised, at which point the option payment would generally be applied to the purchase price, or recognized as taxable income if and when it expires unexercised. If Buyer Y fails to exercise the option, Seller X would keep the option payment.

Loan with Option to Buy

Another two-step approach to selling a parking garage is through a loan coupled with a purchase option. Under this technique, the buyer makes a loan (collateralized by the property) to the seller, and also purchases an option to acquire the property in the future based on a fixed price, or an agreed-upon formula to establish the price of the property in the future. The seller must make interest payments on the loan at a rate at least equal to or exceeding the "applicable federal rate"—the minimum rate established by the U.S. Treasury Department. If structured properly, the seller will not pay taxes on the loan proceeds and will not recognize a gain on the sale of the option until the option is exercised or expires. This technique gives the seller the use of most of the sale proceeds without paying income taxes until a later date when, assuming the option is exercised, the sale is ultimately consummated. The principal disadvantage of this method is that it does not result in the transfer of most of the benefits and burdens of ownership until the option is exercised. This is often unpopular with buyers who want to gain operating control of the property as soon as possible.

Perhaps the most effective technique, and certainly one of the most popular, for deferring the recognition of taxable gain and the payment of taxes until a future date is through tax-free exchanges.

To illustrate this technique, assume that Seller X agrees to borrow $3,000,000 from Buyer Y for five years at 5% interest, with no principal amortization. At that point, Seller X would have received more cash ($3,000,000) through the loan than Seller X would have received on an after-tax basis ($2,950,000; $4,000,000 of cash proceeds less $1,050,000 of income taxes) generated through a conventional sale of Green City. Lastly, Seller X would still have the opportunity to participate in the future growth in Green City's cash flow subject to Buyer Y's purchase option.

Conclusion

Motivated sellers and buyers have a variety of structures available to them to affect the timing of the recognition of taxable income and the payment of income taxes. Any of the aforementioned tax deferral techniques will enable the seller of a parking garage to defer taxes until he or she receives cash in the future. Through careful tax planning and close cooperation, a seller and buyer can structure a transaction to suit the specific tax needs of the seller.

These structures are highly complex and require the expertise of experienced real estate and tax professionals. Consult your real estate and tax advisors for assistance.

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