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Hypotheticals: Numbers 1 & 2

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HYPOTHETICAL #1

Al Albright owns an apartment building in Houston, Texas. Al inherited $4,000,000 in cash in 1985 and used the cash to buy the apartment building because his brother-in-law advised him that real estate in Texas was a good investment. Al had no prior experience in property management. He has considered selling the building because it has deteriorated as a result of his failure to maintain and manage it properly. If Al plans to keep the building, he knows he must make improvements to the property so that he can increase the rents.

Bob Brown and Carol Conrad are interested in buying the building. They have significant property management experience and believe that an investment in the building could be quite profitable if the building were renovated and properly managed. All parties agree that the building is worth $6,000,000 in its present condition. Bob and Carol have indicated that they do not have a third-party financing source that would fund the entire purchase price of the building. They would be interested in buying the building only if Al would agree to seller-financing.

Bob and Carol propose to buy the building from Al for $6,000,000. Bob and Carol have $1,000,000 in available cash, but they need the cash to make the necessary improvements to the property once they have purchased it. Therefore, they propose to buy the building from Al in exchange for a nonrecourse promissory note. Bob and Carol believe that it will take some time to do the renovations and to streamline the management of the building. For that reason, they propose that the note would provide for no payments for the first three years, interest only for the next seven years, and the entire amount of principal and unpaid interest payable in 10 years.

Al would like to consider Bob and Carol's offer because he realizes that his inexperience in real estate has gotten him in over his head. Al's adjusted basis in the building currently is $2,000,000 (assume 20-year life for ACRS deductions, rather than 19-year life). His brother-in-law's tax advisor has indicated to him that the deal may have some negative tax consequences. Al would like advice regarding possible ways to structure the deal to avoid these negative tax consequences.

HYPOTHETICAL #2

Instead, assume that Al is Bob and Carol's father. Al would like to turn over management of the building to his two capable children. Also, although Al (who is 62) does not have a great deal of liquid assets, the value of his estate is quite sizable. Therefore, he would like advice regarding ways in which he might transfer to his children an equity interest in the building to reduce the amount of his taxable estate.