THE NAUTILUS GROUP®

GUIDEPOST

Installment Sales

Installment Sales

Installment sales are a powerful tool for both estate planning and as an income tax strategy (especially regarding real estate). As an estate planning technique, installment sales allow high net worth individuals to sell assets to others, thus freezing the value of their estates and transferring future appreciation of the asset sold. As an income tax strategy tool, installment sales generally allow deferral of income tax until cash payments are received, spreading income over several years to avoid exceeding income thresholds for higher income tax rates, the 3.8% Medicare surtax, and phaseouts of deductions and credits.

Definition of an Installment Sale

An installment sale is defined in Internal Revenue Code (IRC) §453(b)(1) as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition of such property occurs. Certain items are treated as cash received in the year of disposition, such as notes payable on demand and bonds that are readily tradable on a securities market that are received as consideration for a sale of real estate.

Property Ineligible for Installment Sale Reporting

Several property items are ineligible for installment sale reporting.

- Sales of marketable securities are not eligible for installment sale reporting.
- Inventoriable personal property is not eligible for installment sale reporting. (This applies to businesses that sell products.)
- Dealer dispositions of real estate are not eligible for installment sale reporting.
    - A dealer disposition of real property is any disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business. For example, sales of homes in a housing development would not qualify for installment sale reporting. Also, if a taxpayer regularly buys homes, rehabilitates the homes, and then sells such rehabilitated homes without renting them for a period of time, then the taxpayer probably has a trade or business of rehabilitating homes and will not be eligible for installment sale reporting.
    - There are exceptions to dealer disposition sales for property used or produced in the trade or business of farming and for timeshares and residential lots. There is an interest charge paid to the IRS for these sales. The interest is shown as an additional tax on the income tax return but may be eligible for a tax deduction as interest expense.

Structuring an Installment Sale

When an asset is sold in an installment sale transaction, the purchase price is paid by the buyer in installments over a period of years. Generally, the seller and buyer negotiate the terms of sale, which may include the purchase price, interest rate, duration of the installment note, and other payment provisions. Once the terms of the sale are negotiated, the buyer and seller memorialize those terms in an installment sale agreement, whereby property is sold to the buyer in exchange for a promissory note from the seller.

The promissory note should bear, at a minimum, interest at the applicable federal rate (AFR) in effect when the note is executed, based on the duration of the promissory note. Interest at or above the AFR guarantees the sufficiency of the consideration and avoids the imputation of interest. In months where the AFR is low, the buyer has the ability to lock in a low rate for the duration of the payout period. If the transferred asset appreciates at a rate in excess of the interest rate applied on the note, the excess appreciation passes to the buyer at no gift tax cost.

An installment note can take different forms.

Balloon Installment Note or Traditional Amortized Installment Note

The installment note can be structured as an interest-only note with a balloon payment at the end of the installment period, or it can be fully or partially amortized.

In the event of the seller's death while the note remains outstanding, the note would be included in the seller's taxable estate. However, any appreciation in the value of the transferred asset that occurred after the asset was sold is excluded from the seller's taxable estate. In the event of the seller's death after the note is paid in full, neither the note or the transferred asset would be included in the seller's estate.

Self-Cancelling Installment Note

With a traditional installment sale, the balance left unpaid at the seller's death is included in the taxable estate. In contrast, a self-cancelling installment note (SCIN) is designed to remove from the estate the balance of the note remaining at death. This is accomplished through a bargained-for provision in the note, under which all installment obligations automatically cease upon the earlier of full satisfaction of the note or the date of the seller's death. Thus, a SCIN not only freezes the estate tax value of the asset sold, but also removes part of the value from the seller's estate if the seller dies before the note is entirely paid. SCINs are used as an estate tax planning technique when the seller is not expected to live to his/her life expectancy.

To account for the possibility that the seller's life could end prior to full payment, a SCIN must contain a "risk premium" in the form of either an addition to the purchase price or the interest rate. Although there is no specific guidance on how to determine the risk premium, typically, the current interest rates and the seller's life expectancy are factors which should be considered. If the SCIN duration exceeds the seller's life expectancy, it will be considered a private annuity, which does not allow for interest deductions. Assistance from a competent valuation professional should be sought in order to determine the appropriate risk premium.

Private Annuity

In a private annuity sale, the purchase price is generally an unsecured annuity based on the life expectancy of the seller and rates prescribed in IRC §7520. Internal Revenue Service (IRS) actuarial tables cannot be used if the seller is known to have an illness or condition such that there is at least a 50% probability that the seller will die within one year. In exchange for the property, the buyer must make annuity payments for the seller's lifetime. Even if the annuitant lives past his/her life expectancy, the buyer is still required to pay the annuitant an income stream. Upon the seller's death, the property is normally not included in the annuitant's taxable estate.

Tax Considerations

Income Tax

Installment Sale – Generally, the seller will pay income tax only as payments are received. In a standard installment sale of a capital asset (such as real estate, stock, etc.), each payment consists of:

- Return of cost basis (non-deductible to the buyer and non-taxable to the seller);
- Capital gain (non-deductible to the buyer and generating capital gain rates—often long-term—to the seller); and
- Interest (possibly deductible to the buyer as business or investment interest and generating ordinary income to the seller).

However, the IRS may charge interest on the deferred tax on an installment note where both (i) the property had a sales price over $150,000, and (ii) the outstanding balance of all nondealer installment obligations is more than $5,000,000.

Losses incurred on sales between related parties are not deductible. However, if the buyer later re-sells the property at a gain, the previously disallowed loss may offset any appreciation.

If property sold was depreciated, any depreciation recapture that may apply must be reported in the year of sale.

SCINs – While SCINs are taxed much like a standard installment sale, transferring appreciated property has a drawback. The seller's premature death is deemed a "disposition" of the note. As such, any unpaid gain remaining at the seller's death is income taxed at the capital gains rate.

Private Annuities – At one point, private annuities were a fairly popular planning technique because, like an installment sale, gain was deferred until payments were received. However, the IRS has issued proposed regulations that are effective for sales after October 18, 2006. Those regulations provide that the entire gain or loss would be recognized at the time of the transaction. Gain would be calculated by subtracting the seller's cost basis from the present value of the annuity. The tax result would be as if the seller sold the property, then purchased an annuity with the sale proceeds.

Unlike an installment sale, in a private annuity arrangement, the "interest" portion is not deductible by the buyer. If the property is sold before the annuitant's death, the buyer's basis for gain is the total payments actually made plus the actuarial value of future payments as of the date of sale. The buyer's basis for loss is the total amount of payments made as of the date of sale. If the property is sold after the annuitant's death, the obligor's basis for gain or loss is the total of annuity payments made, less any depreciation taken.

Gift Tax

If the transaction represents a bargained-for bona-fide sale, and the purchase price, interest rate, and duration are reasonable when the sale is transacted, no gift should be triggered. When an installment sale occurs between related parties, the interest rate applied should be, at a minimum, equal to the AFR applicable to the length of the installment note. Otherwise, a gift could be imputed. Additionally, for a SCIN, the note should include an appropriate risk premium. If the risk premium is too low, the difference between the market value of the asset and the value of the SCIN will be considered a gift. To avoid risk, it may be prudent to obtain an actuarial valuation of the seller's life expectancy. If, at the inception of a private annuity, the present value of the annuity payments, based on the seller's life expectancy, equals the fair market value of the transferred asset, no gift should result.

Income Tax Compliance

Installment sales are reported on IRS Form 6252, Installment Sale Income. An individual can elect out of installment sale treatment by reporting the sale on IRS Form 4797, Sales of Business Property, or IRS Form 8949, Sales and Other Dispositions of Capital Assets, by the due date of the return for the year the sale takes place and reporting all income from the sale in the year of sale, regardless of when payment is actually received.