



Installment Sales Tax Primer

By Charles A. Wry, Jr.



mbbp.com

Installment Sales Tax Primer

By Charles A. Wry, Jr.

April 2011

I. INTRODUCTION

Deferred sale payments generally consist of interest and principal components. The installment sale rules determine the portions of each principal payment that are gain, on the one hand, and recovered basis, on the other. Basically, the seller is required to compute the percentage of the sum of the principal payments he or she will receive that will constitute gain on the sale and then multiply each principal payment he or she receives by that percentage to determine the portion of the payment that is gain.

II. THE BASIC RULES.

Under Internal Revenue Code (“Code”) Section 453(a), except as otherwise provided in Section 453, income from an “installment sale” is reported using the “installment method.”

A. Installment sale. Code Section 453(b)(1) and Section 15A.453-1(b)(1) of the Income Tax Regulations (the “Regulations”) define an “installment sale” as any disposition of property where at least one payment is to be received in a year after the year of the disposition.

B. Installment method. Under the installment method, the gain from an installment sale is reported as “payments” are received.

1. Basic notion. Under Code Section 453(c) and Regulations 15A.453-1(b)(1), each “payment” is multiplied by the “gross profit ratio” (or “GPR”) determined for the sale. The product of the payment and the GPR is the gain portion of the payment. The balance of the payment is a non-taxable recovery of basis.

Thus: Payment times GPR equals Gain

2. GPR. GPR equals gross profit (“GP”) divided by contract price (“CP”)

a. GP. GP equals selling price (“SP”) minus adjusted basis (“AB”), with AB including any selling expenses paid by the seller. Regulations Section 15A.453-1(b)(2)(v).

b. CP. CP equals SP minus qualifying indebtedness (“QI”) to the extent not in excess of AB (which, again, includes any selling expenses paid by the seller). Regulations Section 15A.453-1(b)(2)(iii).

c. SP. SP equals gross selling price (i) including any mortgage or other encumbrance on the

property and without reduction for any selling expenses paid by the seller, but (ii) excluding any interest or original issue discount (“OID”) payable to the seller. Regulations Section 15A.453-1(b)(2)(ii).

d. **QI.** Under Regulations Section 15A.453-1(b)(2)(iv), QI is (i) any mortgage or other indebtedness encumbering the property and (ii) any indebtedness not secured by the property but incurred or assumed by the purchaser incident to the purchaser’s acquisition, holding or operation of the property in the ordinary course of business or investment. QI does not include, however:

- i. an obligation incurred by the seller incident to the disposition of the property (e.g., legal fees);
- ii. an obligation functionally unrelated to the acquisition, holding or operation of the property (e.g., the seller’s medical bills); and
- iii. an obligation incurred after the seller’s acquisition of the property in contemplation of the disposition of the property if incurring the obligation would result in the acceleration of the recovery of the seller’s basis in the property (that is, in the deferral of the seller’s gain).

3. Payment. Under Regulations Section 15A.453-1(b)(3), the term “payment”:

a. **Excludes:**

i. The seller’s receipt of an evidence of indebtedness of the purchaser, even if guaranteed by a third party.

(1) A standby letter of credit is treated as a third-party guarantee. Under Regulations Section 15A.453-1(b)(3)(iii), a standby letter of credit is defined as a non-negotiable, non-transferable (except with the debt it secures) letter of credit issued by a bank or other financial institution serving as a guarantee of the debt it secures. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of a default.

ii. The purchaser’s assumption of QI to the extent not in excess of the AB of the property sold.

iii. Any payment of interest or OID.

b. **Includes (among other things):**

i. Any principal payment actually or constructively received by the seller in money under an installment obligation.

ii. The purchaser’s assumption of debt that is not QI.

iii. The purchaser’s assumption of QI to the extent it exceeds the AB of the property sold.

- iv. The seller's receipt of an evidence of indebtedness secured directly or indirectly by cash or a cash equivalent (such as a certificate of deposit).
- v. The seller's receipt of an evidence of third party indebtedness.
- vi. The seller's receipt of an evidence of indebtedness that is payable on demand or that is readily tradable under Code Section 453(f)(4) and Regulations Section 15A.453-1(e).
 - (1) "Readily tradable" is defined in Code Section 453(f)(5). The term includes debt that is convertible into readily tradable securities.
- vii. The seller's actual or constructive receipt of a payment of principal in property, subject to any applicable nonrecognition provisions.
- viii. Under Code Section 453(e), if the seller makes an installment sale of property to a related person who makes a second disposition of the property within two years (or at any time thereafter if the property is marketable securities), the amount realized by the related person in the second disposition is a deemed payment to the first seller subject to certain limitations and special rules.

III. EXCEPTIONS.

- A. Sales at loss. Section 453 is not applicable to any sale at a loss.
- B. Dealer dispositions. Under Code Section 453(b), an installment sale does not include any "dealer disposition." Code Section 453(l) defines a "dealer disposition" as (i) any disposition of personal property by a person who regularly sells or otherwise disposes of personal property of the same type on an installment plan, and (ii) any disposition of real property held for sale to customers in the ordinary course of a trade or business (with an exception for sales of unimproved residential lots).
- C. Recapture income. Under Code Section 453(i), recapture income under Section 1245 or Section 1250 (or so much of Section 751 as relates to either of such Sections) is recognized as ordinary income in the year of the disposition. Any remaining gain is reported on the installment method, with the recapture income added to AB.
- D. Sale of depreciable property to related person. Under Code Section 453(g), the installment method is not available for any sale of depreciable property to a related person unless the seller can demonstrate the absence of a tax avoidance purpose (Section 453(g) complements Section 1239).
 - 1. Section 453(g)(3) provides that the term "related person" has the same meaning as under Section 1239(b), except that the term also includes two or more commonly owned partnerships under Section 707(b)(1)(B).
 - 2. "Depreciable property" is defined to mean property of a character subject to the allowance for depreciation under Section 167. Thus, due to Section 197(f)(7), "depreciable property" includes amortizable section 197 intangibles.
- E. Dispositions of personal property under a revolving credit plan. Under Section 453(k)(1), the installment

method is not available for dispositions of personal property under a revolving credit plan.

F. Publicly traded stock or securities. Under Section 453(k)(2), the installment method is not available for sales of publicly traded stock or securities.

G. Accrual method sellers. In December of 1999, the installment method was made unavailable to accrual method sellers. A year later, the rule was reversed retroactively (so that the installment method is available to accrual method sellers).

IV. ELECTION OUT.

A seller may elect out of the installment method (the installment method is the default rule). Under Regulations Section 15A.453-1(d), the election must be made on or before the due date (including extensions) for the seller's return for the year in which the sale is made.

A. No contingent payments. Under Regulations Section 1.1001-1(g)(1), the portion of the seller's amount realized attributable to the debt instrument equals the issue price (or "IP") of the instrument as determined under the OID rules¹.

B. Contingent payments. See V.d. below.

V. CONTINGENT PAYMENT SALES.

A. General. Under Regulations Section 15A.453-1(c)(1), a contingent payment sale is defined as a sale or other disposition in which the SP can not be determined by the close of the taxable year of the sale or other disposition. A contingent payment sale does not include any transaction in which the installment obligation represents a retained interest in the property.

B. Three scenarios.

1. Stated maximum selling price. Regulations Section 15A.453-1(c)(2) applies when there is a stated maximum selling price.

a. In computing GPR, the seller must assume he or she will receive the maximum possible amount (at the earliest possible time). This assumption obviously inflates the SP and GPR and therefore accelerates the reporting of gain.

b. If an event (e.g., failure to hit a milestone) occurs reducing the maximum amount that the seller may receive, the seller recomputes the GPR for the year of the reduction and subsequent years but makes

¹ The IP of a note of a buyer received by a seller in a private sale of non-publicly traded property generally depends on whether the note bears "adequate stated interest." If the note bears adequate stated interest, its IP is its stated principal amount (the sum of all payments due under the note, excluding stated interest). If the note does not bear adequate stated interest, its IP is a lesser "imputed principal amount" determined by discounting all the payments due under the note back to the date of the closing of the sale at a prescribed "test rate."

no corrections for prior years. Essentially, the seller starts over in the year of the adjustment, using his or her unrecovered basis as AB and the payments that he or she can still receive to determine SP in recomputing GPR.

c. The seller may not take a loss until such time as he or she has unrecovered basis and no rights to further payments. Then, the seller has a loss equal to his or her unrecovered basis. The character of the loss should be determined under Code Section 453B with reference to the nature of the property sold².

2. No stated maximum selling price, but fixed payment period. Regulations Section 15A.453-1(c)(3) applies when there is no stated maximum selling price but there is a fixed period over which the seller may receive payments.

a. The seller's AB (again, which includes selling expenses paid by the seller) is allocated to the years in which payments may be received in equal annual increments (or in accordance with an arithmetic component set forth in the applicable purchase and sale agreement unless it is inappropriate to assume that payments will be made in accordance with the component).

b. If for any taxable year the payment received is less than the amount of AB allocated to the year, the unrecovered portion of the AB allocated to the year is carried over to the next year (and the seller reports no loss) unless the year is the last year of the payment period or the future payment is worthless under the bad debt rules.

i. Again, the character of the loss should be determined under Section 453B with reference to the nature of the property sold.

3. Neither stated maximum selling price nor fixed payment period. Regulations Section 15A.453-1(c)(4) applies when there is neither a stated maximum selling price or a fixed period over which the seller may receive payments.

a. The Regulations first require an examination of whether a sale has realistically occurred or whether, in economic effect, payments are in the nature of rent or royalty income.

b. If the arrangement is a sale, the seller's AB is recovered in 15 annual increments beginning with the year of the sale.

c. If for any taxable year the payment received by the seller is less than the AB allocated to the year, the unrecovered basis for the year is re-allocated ratably over the remaining years in the 15 year period (and no loss is allowed) unless the future payment obligation is worthless under the bad debt rules.

d. If the seller has unrecovered basis left at the end of the 15 year period, the seller keeps carrying the unrecovered basis forward until he or she has recovered the basis or until the future payment obligation becomes worthless.

i. Again, the character of the loss should be determined under Section 453B with reference to the nature of the property sold.

² Language in examples in the Regulations indicates that the worthless debt rules may apply. See, for example, Regulations Section 15A.453-1(c)(2)(iii), Example 5.

C. Special rule to avoid substantial distortion.

1. Under Regulations Section 15A.453-1(c)(7), the seller may use an alternative method if he or she can demonstrate, prior to the due date of his or her return (including extensions) for the year in which the first payment is received, that the application of the rule that would otherwise apply will “substantially and inappropriately defer the recovery of basis.”

2. The alternative method must (i) be reasonable and (ii) result in the recovery of the seller’s basis at least twice as fast as the recovery rate that would otherwise apply.

3. The seller must apply for a ruling (which has practical implications).

D. Election out.

1. **Open transaction doctrine.** The “open transaction doctrine” can apply in limited instances where the future payment stream is so speculative that it can not reasonably be valued. If the seller can fall within the doctrine, he or she can recover his or her entire basis first, with the payments received after basis has been recovered constituting gain. Under Regulations Section 15A.453-1(d)(2)(iii), however, it is only in “rare and extraordinary” cases that the value of a payment stream will not be reasonably determinable.

2. **Closed transaction doctrine.** If the open transaction doctrine does not apply, the seller has a closed transaction and reports the results accordingly.

a. Under Regulations Section 1.1001-1(g)(2), the portion of the seller’s amount realized attributable to the debt instrument equals:

- i. The IP of the noncontingent component (if any); plus
- ii. The fair market value (or “FMV”) of any contingent payments.

b. The right to the contingent payments is treated as a separate debt instrument with a basis in the seller’s hands equal to the FMV assigned to the contingent payments for purposes of determining the seller’s amount realized. As contingent payments are received, they are first applied in reduction of the seller’s basis. Once basis has been recovered, the excess is gain from the sale or exchange of the debt instrument under Regulations Section 1.1275-4(c)(5)(iii).

c. Under the “separate item of property” theory, any gain or loss with respect to the debt instrument representing the right to the contingent payments should be determined with reference to the nature of that debt instrument in the seller’s hands and the seller’s holding period for that debt instrument (rather than with reference, if Section 453B were applicable, to the nature of the asset sold by the seller for the instrument and the seller’s holding period for that asset). In that case, electing out of the installment method could result in character differences from the results that would have applied under the installment method.

- i. Example. Suppose that the seller sells a Section 1231 asset with an adjusted basis of \$500 for \$500 cash at closing and a contingent right to receive up to another \$500 after two years. The value of the contingent right is \$200. After two years, the seller receives a contingent payment of only \$100. Ignore, for purposes of the example, interest and recapture.

(x) If the seller uses the installment method, he or she reports \$250 of Section 1231 gain in the year of the sale and takes a \$250 basis in his or her right to receive the contingent payment (because of the rule requiring the calculation of GPR based on an assumption that the seller will receive the full \$500). Then, when the seller receives only \$100 after two years, he or she has a \$150 Section 1231 loss under 453B³.

(y) If the seller elects out of the installment method (and assuming the inapplicability of the open transaction doctrine), he or she reports \$200 of Section 1231 gain in the year of the sale and takes a \$200 basis in his or her right to receive the contingent payment. Then, when he or she receives a contingent payment of only \$100 after two years, he or she has a \$100 loss that should be a long-term capital loss (assuming the right to the contingent payment was a capital asset in his or her hands) unless there's a theory, such as Arrowsmith, he or she can rely on to determine the character of the loss with reference to the property he or she sold.

d. Point to note: In a contingent payment sale, the seller may get a better result electing out of the installment method if the value of the contingent payments is low. Beware, however, any potential character differences resulting from the election out.

e. Practical implications. The way that the installment sale rules apply to a contingent payment sale can cause the seller to report too much gain in the early years and even a loss in a later year that may not be carried back. When faced with this possibility, it is important to consider whether the seller should try to use an alternative method or even elect out of the installment method. The seller should also attempt to negotiate the contingent payment terms of the sale so as to maximize the likelihood of his or her receiving the maximum amount.

VI. INTERACTION WITH OTHER PROVISIONS.

A. **OID rules.** Because the installment sale rules do not apply to interest or OID, the OID rules should be applied first to carve any interest or OID payments out of the expected payment stream.

B. **Sections 1231 and 1(h).**

1. Under Regulations Section 1.1231-1(d)(4), Section 1231 gain on an installment sale is reported ratably as it is recognized on the installment method.

2. Under Regulations Section 1.453-12, to the extent the sale or other disposition generates any "unrecaptured Section 1250 gain," it is the first gain recognized.

3. Under Regulations Section 1.453-12, to the extent any portion of what would otherwise be

³ In TAM 9649005, the Internal Revenue Service ruled (citing Rev. Rul. 64-178, 1964-1 CB 171) that, notwithstanding Arrowsmith, the loss on facts similar to these could be ordinary even though the Section 1231 gain in the earlier year was reported at long-term capital gain rates.

long-term capital gain is recharacterized as ordinary income under Section 1231(c), the first gain is what is so recharacterized.

VII. SECTION 453A.

Section 453A applies, subject to certain exceptions and special rules, to a seller who disposes of property using the installment method if the sales price of the property exceeds \$150,000.

A. Interest charge.

1. If the seller receives an installment obligation during any year that remains outstanding as of the close of the year, he or she will be required to pay an interest charge on a portion of the tax liability that is deferred for the year with respect to the obligation by his or her use of the installment method if he or she holds installment obligations that arose during and remain outstanding as of the close of the year having an aggregate face amount greater than \$5,000,000. The portion of the deferred tax liability with respect to the obligation to which the interest charge applies is determined by multiplying the deferred tax liability by a fraction (A) the numerator of which is (x) the aggregate face amount of the installment obligations held by the seller that arose during and remain outstanding as of the close of the year minus (y) \$5,000,000, and (B) the denominator of which is the aggregate face amount of the installment obligations held by the seller that arose during and remain outstanding as of the close of the year.

2. Once an obligation is subject to the interest charge rule, it remains subject to the rule until it is discharged.

B. No pledging rule. The proceeds of any pledging transaction with respect to the obligation are treated as a payment.

VIII. SECTION 453B.

A. Disposition of installment obligation. If an installment obligation (an obligation of the purchaser received by a seller in an installment sale and to which the installment method applies) is satisfied at other than face value or is distributed, transmitted, sold or otherwise disposed of, the seller recognizes gain or loss equal to the difference between:

1. the basis of the obligation, and

2. the amount realized (in the case of a satisfaction, sale or exchange of the obligation) or the FMV of the obligation (in the case of a distribution, transmission or disposition that is not a sale or exchange).

a. Except as provided in Section 1038 (which deals with certain reacquisitions of real estate), if an installment seller receives back the property he or she sold in satisfaction of the installment obligation he or she received in the sale, the value of the property is treated as his or her amount realized from the disposition of the installment obligation.

B. Character. The gain or loss is of the same character as the gain or loss from the sale or exchange of the property in respect of which the obligation was received.

- C. Basis of obligation. The basis of an installment obligation is the excess of:
1. the face value of the obligation, over
 2. the income that would be returnable by the seller if the obligation were satisfied in full.
- D. Exceptions. Exceptions apply, including for:
1. Transfers at death (note the absence of any exception for lifetime gifts).
 2. Transfers between spouses (transferee steps into shoes of transferor).

This article is not intended to constitute legal or tax advice and cannot be used for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending any transaction or matter addressed herein