Installment Sales

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Installment Sales

An installment sale is a sale of property where one or more payments are received after the close of the tax year. This mini-course discusses the particulars of installment sales, including requirements, calculations, and pitfalls. Cross issues such as a combined installment sale and like-kind exchange, the impact of related parties, pledging, repossession and contingent payments are reviewed. Also, the importance of recognizing the dangers of dealer status, inventory, purchase price allocation, and installment note disposition are emphasized.

Course Level: Overview. This program is appropriate for professionals at all organizational levels.

Field of Study: Taxes

Prerequisite: General understanding of federal income taxation.

Advanced Preparation: None

Recommended CPE Hours: CPAs — 2 Tax
EAs and CRTPs — 2 Federal Tax

Expiration Date: July 2024

Learning Assignment & Objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

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ASSIGNMENT

At the start of the materials, participants should identify the following topics for study:

* Installment method
* Installment income
* Imputed interest & OID
* Related party sales
* Like-kind exchanges
* Contingent payments or price
* Sale of a business
* Dealer dispositions
* Installment notes in excess of $5 million
* Dispositions of installment obligations

Learning Objectives

After reading the materials, participants will be able to:

1. Recognize the importance, particularly in tax deferral, of the installment method and, identify §453 requirements and installment method terminology.

2. Specify the imputed interest, OID, and §1038 repossession rules affecting installment sales and subsequent repossessions.

3. Identify the following §453 pitfalls and complexities: the related party limitation, the regulations governing the use of the installment sale method in like-kind exchanges, and the contingent payment sale rules.

4. Determine how to allocate and report installments payments among identified asset classes using R.R. 76-110 and the residual method recognizing §453 prohibitions on certain assets regarding dealer dispositions and inventory.

5. Identify the amount of interest payable on tax-deferred income when §453 dispositions exceed $5 million and circumstances considered taxable dispositions of installment obligations to determine when any gain or loss is recognized.

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Installment Sales

By

Danny C. Santucci

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Installment Sales



Installment Method

Under the general rule of taxation contained in §1001, gain from the sale or other disposition of property is the excess of the amount realized over the property's adjusted basis. An exception to this general rule is the installment method.

Without the installment method, taxpayers would be required to immediately report all gain on the sale of property even when sold for terms (*Warren Jones v. Commissioner*, 75-2 U.S.T.C. Par. 9732 (C.A. 9, 1975)). The installment sale method allows taxpayers to report the *gain* on the sale of property as they receive the money from the sale.

An installment sale is a sale of property where one or more payments are received after the close of the tax year. However, the installment sale rules do not apply to the sale of inventory.

> **Note:** When a seller finances the buyer's purchase of the seller's property, instead of having the buyer get a loan or mortgage, it is probably an installment sale. It is not an installment sale if the buyer borrows the money from a third party and then pays the seller the total selling price.

If a sale qualifies as an installment sale, taxpayers must report it on the installment method unless they elect to recognize gain on the sale under the regular method of accounting. Under the installment method, the seller reports gain on the sale only as payments are received. It does not matter whether the seller uses the cash or accrual method of accounting.

Requirements

Taxpayers (other than dealers in personal property) who desire to use the installment method must meet the requirements set forth in §453:

(1) There must be a sale of property (as contrasted to services),

(2) The property must not be of a kind that is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year (§453(b)(1)(B)), *and*

(3) There must be an installment sale (§453(b)(1)).

> **Note:** All that is needed to meet this requirement is that at least one payment will be received in a tax year other than the year of sale.

If the above requirements are met, installment sale treatment is automatic. A special election must be made to report the gain by any other method of accounting.

Formula

The *gain* reported on an installment sale is computed using the following formula:

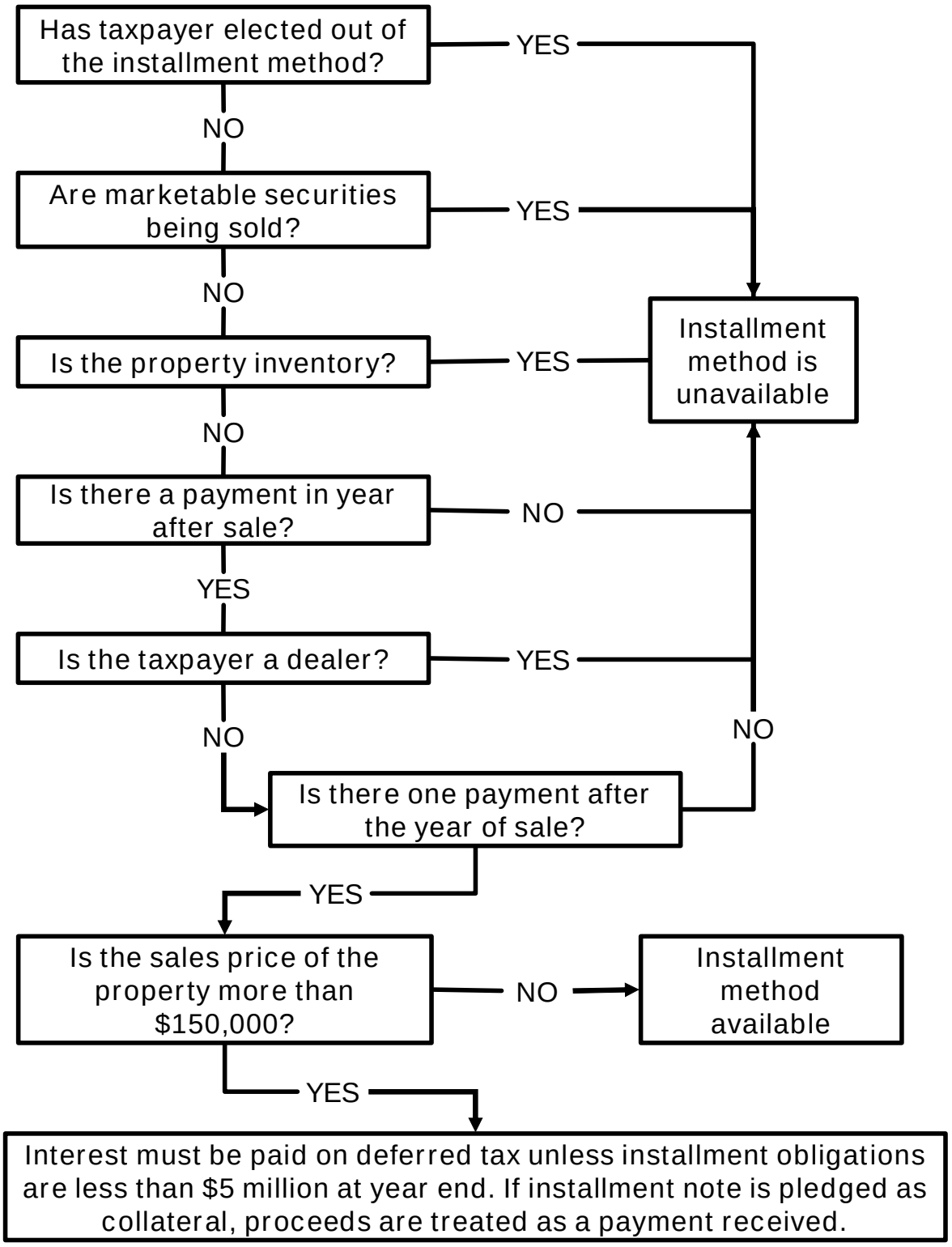
$$\frac{\text{Total Gain}}{\text{Contract Price}} \times \text{Payments Received During Tax Year} = \text{Recognized Gain}$$

Historically, *losses* sustained on an installment sale were fully deductible in the year of sale (R.R. 70-430). This rule has been modified by §469 that now requires installment reporting of certain losses (e.g., suspended losses under the passive loss limitation rules) in an installment sale.

Dealers

Sales of personal property by a dealer or anyone who regularly sells property on the installment plan cannot be reported on the installment method for federal income tax purposes. This also applies to real property held for sale to customers in the ordinary course of the trade or business. However, this does not apply to a sale on the installment plan of any property used or produced in the trade or business of farming (§453(l)).

Installment Sales



Note: Dealers are merchants who regularly sell personal property (such as stereos, autos, and furniture) on the installment plan. Non-dealers are taxpayers who do not regularly sell on the installment plan or taxpayers who regularly sell on the installment plan, but who sell real property.

Special Rule

Dealers of timeshares and residential lots can report sales on the installment method if they elect to pay interest on installment obligations for these sales (§453(l)).

Sale at a Loss

If a sale results in a loss, the installment method may not be used. If the loss is on an installment sale of business assets, the loss can only be deducted in the tax year of the sale. A loss on the sale of property owned for personal use cannot be deducted (R.R. 70-430; §165(c)).

Note: If a sale calls for payments in a later year, and there is little or no interest provided for in the contract of sale, a taxpayer may have to figure unstated interest even though they have a loss (§483).

Installment Income

Each payment on an installment sale usually consists of *three* parts:

(1) Return of investment (basis) in the property sold,

(2) Gain on the sale, *and*

(3) Interest.

Each year a payment is received, the interest part of the payment, as well as the part of the payment that is gain, must be included in income. The part of the payment that is the return of basis in the property sold is not included in income.

Interest Income

If interest is included in a payment, all interest must be reported as ordinary income. Interest is generally not included in a downpayment. However, a seller may have to treat part of each later payment as interest, even if it is not called interest in the agreement with the buyer (§483).

Gain

After the interest portion, the balance of each payment is treated as if it were made up of *two* parts:

(1) A return of investment (basis) in the property sold, *and*

(2) Gain from the sale.

Note: The gain is capital gain if the property sold was a capital asset. However, if depreciation deductions were taken on the asset, part of the gain may be treated as ordinary income (§453(i)).

To determine what part of a payment is gain (profit), first determine the gross profit percentage. The gross profit percentage is figured by dividing the gross profit on the sale by the contract price. The following worksheet, which is based on Form 6252, *Installment Sale Income*, gives the basic items to figure the gross profit percentage.

1. Selling price		$_____
2. Minus the sum of:		
Basis of property sold	$_____	
Selling expenses	$_____	
Depreciation recapture	$_____	$_____
3. Gross profit (line 1 less line 2)		$_____
4. Contract price		$_____
5. Gross profit percentage (line 3 divided by line 4)		_____



Definitions & Terminology

The regulations contain a number of key definitions and terminology defining the installment method and identifying components to necessary calculations (e.g., see Reg.§ 15A.453-1). The terminology and definitions appear repeatedly throughout this text and are summarized here.

Installment Sale

The term "installment sale" means a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs (Reg.§ 15A.453-1(b)(2)).

Note: The term "installment sale" includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale. However, the term does not apply to inventory.

Selling Price

The selling price for an installment sale is the entire cost of the property to the buyer. It includes any money and the fair market value of any property received. It also includes any debt the buyer pays, assumes, or takes the property subject to. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes owed on the property. If the buyer pays any of the seller's selling expenses, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated (IRS Pub. 537; Reg. §15A.453-1(b)(2)(ii); R.R. 76-109).

> **Note:** The selling price is the total consideration received for the sale of the property. "Consideration" includes cash, the buyer's note or mortgage given to evidence the debt, liabilities of the seller assumed (or taken subject to) by the buyer, and the FMV of other property received from the buyer in the transaction.

Selling Price Reduction

If the selling price is reduced at a later date, the gross profit on the sale will also change. The seller must then refigure the gross profit percentage of the remaining payments. Gross profit is refigured, using the reduced sale price, subtracting profit already reported, and spreading the remaining gain evenly over the remaining installments. The seller cannot go back and refigure the gain reported in earlier years (R.R. 72-570).

Example

In 2023 Dan sold land with a basis of $40,000 for $100,000 and had a gross profit of $60,000. Dan received a $20,000 downpayment and the buyer's note for $80,000. The note provides for 4 annual payments of $20,000 each, plus 8% interest, beginning in 2024. Dan's gross profit percentage is 60%. He reported a gross profit of $12,000 on payments received in 2023 and 2024. In 2025, Dan and the buyer agreed to reduce the purchase price to $85,000 and payments during 2025, 2026, and 2027 are reduced to $15,000 for each year.

Dan's adjusted gross profit on the sale is $45,000. Dan subtracts the total profit reported in 2023 and 2024, or $24,000, from the adjusted gross profit to determine the remaining profit to be reported. The remaining profit to be reported ($21,000) is divided by the selling price to be received of $45,000 ($85,000 - $40,000) to get the new gross profit percentage of 46.67%. Dan will report a gross profit of $7,000 on each of the $15,000 installments due in 2025, 2026, and 2027 (R.R. 72-570).

Allocation

The total selling price and amounts received in the year of sale (see discussion below) of multiple properties under a single contract must be allocated, on the basis of their proportionate net fair market value - i.e., FMV reduced by any encumbrance assumed or taken subject to (R.R. 76-110).

Basis & Adjusted Basis

Basis is a way of measuring the investment in the property being sold. Basis depends on how the property was first acquired. The basis of purchased property is usually its cost. The basis of property inherited, obtained as a gift, built by the owner, or received in a tax-free exchange is figured differently (§1011; §1016).

While property is owned, various events may change the original basis in the property. Some events, such as additions or permanent improvements, increase basis. Others, such as deductible casualty losses and depreciation, decrease basis. The result is adjusted basis.

Installment Sale Basis

The adjusted basis plus selling expenses and depreciation recapture income is referred to as the installment sale basis.

Selling Expense

Selling expenses are those that relate to the sale of the property. They include commissions, attorney fees, and any other expenses paid on the sale. Selling expenses are added to the basis of the sold property in determining the gross profit on the sale (IRS Pub. 537; Reg. §15A.453-1(b)(2)(v)).

Gross Profit

For an installment sale, gross profit is the amount of gain reported on the installment method. To figure gross profit, the adjusted basis in the property sold and the selling price must be known. Commissions and other expenses paid on the sale are added to the adjusted basis for the property. The adjusted basis, as increased, is then subtracted from the selling price to determine gross profit. If the property sold was the seller's home, subtract from the gross profit any gain that can be postponed or excluded. The result is the seller's gross profit from the sale (IRS Pub. 537; Reg. §15A.453-1(b)(2)(v)).

Contract Price

The contract price is the total of all principal payments to be received on the installment sale. It includes payments you are considered to receive, even

though you are not paid anything directly (IRS Pub. 537; Reg. §15A.453-1(b)(2)(iii)).

> **Note:** If the selling price is partly payable in cash, with the remainder secured by a mortgage payable from the buyer to you, then the contract price equals the selling price (IRS Pub. 537; Reg. §15A.453-1(b)(2)(iii)).

The contract price is the total amount the seller will receive (exclusive of interest) when the transaction is finally completed. This amount is usually equal to the selling price less the seller's debt assumed (or taken subject to) by the buyer.

Wrapped Debt

Prior to the Installment Sale Revision Act of 1980, any indebtedness on which the seller remained liable (e.g., contract for deed or wrap-around mortgage) was not subtracted from the contract price but included in it (Stonecrest v. Commissioner, 24 T.C. 659 (1955) and Hunt, 80 T.C. 1126 (1983)). This inclusion could greatly reduce the recognized gain based on the installment method formula above.

However, with the passage of the Revision Act, the Service took the position in Temp. Reg. Sec. 15a.453-1 (b)(3)(ii) that:

"The wrapped indebtedness shall be deemed to have been taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness."

The validity of this position was questioned in Professional Equities, Inc., 89 TC 165 (1987). Since in a wrap-around transaction there is no assumption or taking subject to by the buyer, the court held that the total contract price is the sales price unreduced by the amount of any assumed or taken subject to debt. In 1988, the IRS agreed with this position (1988-2 CB 1).

Gross Profit Percentage

A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. This percentage usually remains the same for each payment received. It is called the "gross profit percentage," and is figured by dividing the gross profit from the sale by the contract price (IRS Pub. 537; Reg. §15A.453-1(b)(2)(i)).

Example

Dan sells property at a contract price of $2,000, and his gross profit is $500. His gross profit percentage is 25% ($500 divid-

ed by $2,000). After subtracting interest, 25% of each payment, including the down payment, is reported as gain from the sale for the tax year the payment is received.

Income from Sale

Each year the seller receives a cash payment on the installment sale, the payment (less interest) is multiplied by the gross profit percentage to determine the amount that must be included in income for the tax year. In certain circumstances, the seller may be considered to have received a payment, even though they received nothing directly. In addition to the receipt of cash, a receipt of property or the assumption of a mortgage on the property sold may be considered payment (IRS Pub. 537; Reg. §15A.453-1(b)(3)).

Payments in Year of Sale

Payments in the year of sale include cash received as a downpayment, FMV of other property received in the year of sale (unless that property is "like-kind" property), and the portion of any of seller's debt that is assumed (or taken subject to) by the buyer and which exceeds the seller's basis for the property sold. Payments in the year of sale do not include debt instruments given by the buyer to evidence the debt to the seller (§453(f)(3)). However, if the instrument is payable on demand or readily tradable it will be treated as receipt of payment (§453(f)(4)). For a more detailed discussion of payments in the year of sale, see the "Payments" section later in the text.

Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

1. The formula for recognized gain on §453 installment sales involves several items. What item is defined as everything received from a property sale?

a. the selling price.

b. the contract price.

c. the gross profit.

d. the recognized gain.

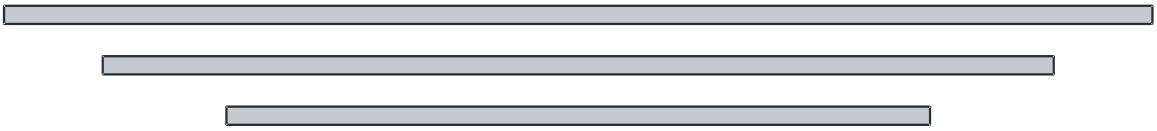
2. Completing the §453 installment sale worksheet requires an understanding of what is meant by "payments in the year of sale." Which of the following is excluded from such payments?

a. cash the seller receives from the buyer as a down payment.

b. debt instruments the buyer gives to the seller to prove the debt.

c. FMV of property that is not like-kind and is received in the sale year.

d. the portion of the seller's debt that is assumed by the buyer and which exceeds the seller's basis for the property sold.



Electing Out of the Installment Method

A taxpayer can choose not to have the installment sale rules apply to their sale. If a taxpayer makes this choice, they report their entire gain from the sale on the return for the year of sale, even though they will not be paid the entire selling price until later (IRS Pub. 537; Reg. §15A.453-1(d)).

Selling Price

To figure the selling price under this method, figure the buyer's installment obligation to the seller at its fair market value. Notes, mortgages, and land contracts are examples of obligations that are included at fair market value in figuring the selling price. If the taxpayer does not elect out, these obligations are included at their full face value (IRS Pub. 537; Reg. §15A.453-1(d)(2)).

Fair Market Value

If the seller elects out of the installment method, they must figure the fair market value of the buyer's installment obligation, whether or not the seller would actually be able to sell it. If the seller uses the cash method of accounting, the fair market value of the obligation will never be considered less than

the fair market value of the property sold (minus any other consideration received). If the seller uses an accrual method of accounting, they must always use the full face value of the installment obligation as its fair market value when they elect out (IRS Pub. 537; Reg. §15A.453-1(d)(2); Reg. §15A.453-1(d)(2)(ii)).

Example

Dan sold a parcel of land to another person for $50,000, payable $10,000 down and the balance over a period of 10 years at $4,000 a year, plus 8% interest. The buyer gave Dan a note for $40,000. The note had a fair market value of $40,000. Dan paid a commission of 6%, or $3,000, to a broker for negotiating the sale. The land cost Dan $25,000 and he owned it for more than one year. Dan decides to elect out of the installment method, and report the buyer's note at its fair market value.

Computation of gain:		
Selling price		*$50,000*
Minus:		
Adjusted basis of the property	*$25,000*	
Commission	*3,000*	*28,000*
Gain realized		*$22,000*
Gain recognized in year of sale:		
Cash		*$10,000*
Market value of note		*40,000*
Total realized in year of sale		*$50,000*
Minus:		
Adjusted basis of the property	*$25,000*	
Commission	*3,000*	*28,000*
Gain recognized in year of sale		*$22,000*

The $22,000 is long-term capital gain. Since Dan includes the full amount of gain in income in the year of sale, he does not include any amount in income when he receives principal payments in later tax years. The interest on the note is reported as interest income on Form 1040 (§1221).

How to Elect Out

To make this choice, do not report the sale on Form 6252. Instead, report it on Form 1040, Schedule D (*Capital Gains and Losses*), or Form 4797 (*Sales of Business Property*), whichever is appropriate. When a seller reports the total selling price, including the full amount of the buyer's obligation, on the

year of sale tax return, it constitutes an effective election out of the installment method (Reg. §15A.453-1(d)(3)(i).).

If the seller elects out and also values the buyer's installment obligation at less than its face value, the seller must also report this election on either Schedule D or Form 4797 by completing an additional part entering the face amount of the buyer's obligation and the percentage of the face amount being reported in the year of sale. (§453(d)(2); Reg. §15A.453-1(d)(3)(i)).

When to Elect Out

The election not to have the installment sale rules apply must be made by the due date, including extensions, for filing the tax return for the year the sale takes place. Once made, the election generally cannot be changed. However, taxpayers can apply to revoke their election not to use the installment sale rules. A revocation of the election will not be permitted when one of its purposes is to avoid federal income tax, or when the tax year in which any payment was received has closed (IRS Pub. 537; Reg. §15A.453-1(d)(3),(4)).



Payments

A seller must figure their profit each year on the payments they receive or are treated as receiving, from an installment sale, including the down payment and each later payment of principal on the buyer's debt (IRS Pub. 537; Reg. §15A.453-1(b)(2)(ii)).

In certain situations, the seller is considered to have received a payment, even though the buyer does not pay the seller directly. These situations arise if the buyer takes over or pays off any of the seller's debts, such as a loan, or any of the seller's expenses, such as a sales commission (IRS Pub. 537; Reg. §15A.453-1(b)(3)).

Buyer's Note

The buyer's note (unless payable on demand) is not considered payment on the sale. Its full face value is included when figuring both selling price and contract price. Payments the seller receives on the note are reported on the installment method (IRS Pub. 537; Reg. §15A.453-1(b)(3)).

Assumed Expenses

If the buyer assumes and pays the seller's expenses from selling the property, it is considered a payment to the seller in the year of sale. These expenses are included in both the selling and contract prices when figuring the gross profit percentage (R.R. 76-109).

Mortgage Assumed

If the buyer assumes or pays off the seller's mortgage, or otherwise takes the property subject to it, the following rules apply.

Mortgage Less Than Basis

If the buyer assumes a mortgage that is less than the seller's installment sale basis in the property, it is not considered a payment to the seller. The contract price equals the selling price minus the mortgage. This difference is all that the seller will directly collect from the buyer (IRS Pub. 537; Reg. §15A.453-1(b)(3)(i)).

Example

Dan sells property with an adjusted basis of $19,000. He has selling expenses of $1,000. The buyer assumes Dan's existing mortgage of $15,000 and agrees to pay Dan a total of $10,000, a cash downpayment of $2,000 and $2,000 (plus 8% interest) in each of the next 4 years.

The selling price is $25,000 ($15,000 + $10,000). The contract price is $10,000 ($25,000 - $15,000 mortgage). Dan's gross profit is $5,000 ($25,000 - $20,000 installment sale basis), and his gross profit percentage is 50% ($5,000 divided by $10,000). Therefore, Dan reports half of each $2,000 payment received as gain from the sale. Dan also reports all interest he receives as ordinary income.

Mortgage More Than Basis

If the buyer assumes a mortgage that is more than the seller's installment sale basis in the property, the seller recovers their entire basis. The seller is also relieved of the obligation to repay the amount borrowed. The part of the mortgage in excess of seller's basis is treated as a payment received in the year of sale. This is in addition to the buyer's other payments (IRS Pub. 537; Reg. §15A.453-1(b)(2)(iii); Reg. §15A.453-1(b)(2)(v); Reg. §15A.453-1(b)(3)).

To figure the contract price, subtract the mortgage from the selling price. This is the total seller will actually receive from the buyer. To this amount, add the "payment" seller is considered to receive (the difference

between the mortgage and seller's installment sale basis). The contract price is then the same as seller's gross profit from the sale. Therefore, if the mortgage the buyer assumes is equal to or more than seller's installment sale basis in the property, the gross profit percentage will always be 100%.

Example

The selling price for Dan's property is $9,000. The buyer will pay Dan $3,000 (plus 8% interest) over the next 3 years and assume an existing mortgage of $6,000. Dan's adjusted basis in the property is $4,400. He has selling expenses of $600, for a total installment sale basis of $5,000. The part of the mortgage that is more than his installment sale basis is $1,000 ($6,000 - $5,000). This amount is included in the contract price and treated as a payment received in the year of sale. The contract price is $4,000 ($9,000 - $6,000 + $1,000).

Dan's gross profit on the sale is also $4,000 ($9,000 - $5,000). Therefore, his gross profit percentage is 100%. As the buyer pays Dan the $3,000, he must report 100% of each payment as gain from the sale. Dan also treats the $1,000 difference between the mortgage and his installment sale basis as a payment and reports 100% of it as gain in the year of sale.

Wrap-around Mortgages

If the seller's mortgage is not paid off or assumed by the buyer when the property is sold, the installment arrangement with the buyer is known as a "wrap-around mortgage." In a wraparound mortgage, the installment payments the seller receives are ordinarily large enough to allow the seller to continue to make regular mortgage payments on the property.

The amount of a wrap-around mortgage is not subtracted from the selling price to determine the contract price. However, if the mortgage is in fact assumed, or taken subject to, the amount of the mortgage is subtracted from the selling price to figure the contract price (*Professional Equities, Inc.*, 89 T.C. 165 (Acq); *Stonecrest Corp.*, 24 T.C. 659 (1955) Acq Oct. 11, 1974).

Mortgage Canceled

If the buyer of seller's property is the person who holds the mortgage on it, seller's debt is not assumed but canceled. The seller is considered to receive a payment equal to the outstanding amount of the canceled debt (IRS Pub. 537; Reg. §15A.453-1(b)(3)(i)).

Example

Mary loaned Dan $4,500 in 2023 in exchange for a note mortgaging a tract of land Dan owned. On April 4, 2026, she bought the land for $7,000. At that time, $3,000 remained outstanding on her loan to Dan. She agreed to forgive this $3,000 debt and to pay Dan $2,000 (plus interest) on August 1, 2026, and $2,000 (plus interest) on August 1, 2027. She did not assume an existing mortgage. She canceled the $3,000 debt Dan owed her. The effect is that Dan received a $3,000 payment at the time of the sale.

Debts

If the buyer pays off any of the seller's debts, such as a loan or back taxes, it may be considered a payment to the seller in the year of sale (IRS Pub. 537; Reg. §15A.453-1(b)(3)(i)).

If the buyer assumes the debt instead of paying it off, only a part of it may have to be treated as a payment. Compare the amount of the debt to the seller's installment sale basis in the property being sold. If the debt is less than the seller's installment sale basis, none of it is treated as a payment. If it is more, only the difference is treated as a payment. If the buyer assumes more than one debt, any part of the total that is more than the seller's installment sale basis is considered a payment. This follows the rules for mortgages that are assumed (IRS Pub. 537; Reg. §15A.453-1(b)(3)(i)).

However, these rules apply only to *two* types of debts that the buyer assumes:

(1) Those the seller acquired from ownership of the property, such as a mortgage, lien, overdue interest, or back taxes (IRS Pub. 537; Reg. §15A.453-1(b)(2)(iv); Reg. §15A.453-1(b)(3)(i)), *and*

(2) Those the seller acquired in the ordinary course of business, such as a balance due for inventory purchased (R.R. 73-555).

If the buyer assumes any other type of debt, such as a personal loan, it is treated as if the buyer paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to the seller in the year of the sale (IRS Pub. 537; Reg. §15A.453-1(b)(2)(iv); Reg. §15A.453-1(b)(3)(i)).

Payments of Property

If the seller receives property rather than money from the buyer, it is still considered a payment. The value of the payment is the property's fair market value on the date seller receives it (IRS Pub. 537; Reg. §15A.453-1(b)(3)(i); §1001(b)).

Fair Market Value

Fair market value is the price at which the property would change hands between a buyer and a seller, neither being required to buy nor sell and both having reasonable knowledge of all the necessary facts. If the installment sale fits this description, the value assigned to property in the agreement with the buyer is good evidence of its fair market value (IRS Pub. 537; Reg. §20.2031-1).

Third-Party Notes

If the property the buyer gives the seller is a third-party note (or other obligation of a third party), the seller is considered to have received a payment equal to the note's fair market value. Because the note is itself a payment on the installment sale, any payments the seller later receives from the third party are not considered payments on the sale. If the fair market value of the note was less than its face value, a part of each payment received must be reported as ordinary income (IRS Pub. 537; Reg. §15A.453-1(b)(3)(i)).

Example

Dan sold real estate in an installment sale. As part of the downpayment, the buyer assigned Dan a $5,000, 8% note of a third party. The fair market value of the third-party note at the time of the sale was $3,000. This amount, and not $5,000, is a payment to Dan in the year of sale. Because the third-party note had a fair market value equal to 60% of its face value ($3,000 divided by $5,000), 60% of each payment of principal Dan receives on this note is a return of capital. The remaining 40% is ordinary income. The interest Dan receives is reported in full as ordinary income.

Bonds

A bond or other evidence of indebtedness the seller receives from the buyer that is payable on demand is treated as a payment in the year received. If the seller receives a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, the seller is considered to have received payment equal to the bond's fair market value (IRS Pub. 537; Reg. §15A.453-1(e)(3)(i)).

Guarantees

If a third party or government agency guarantees the buyer's payments to the seller on an installment obligation, the guarantee itself is not considered payment (IRS Pub. 537; Reg. §15A.453-1(b)(3)).

Deposits

Deposits that the seller receives before the year of sale are treated as payments in the year of sale if, under the contract, they become part of the downpayment (R.R. 73-369).

Pledging

If a taxpayer uses an installment obligation to secure any debt, the *net* proceeds from the debt may be treated as a payment on the installment obligation. This is known as the pledge rule. The pledge rule applies to sales of certain property over $150,000. It does *not* apply to the sale of:

(1) Property used or produced in the trade or business of farming, *or*

(2) Personal use property (§453A(b)(3); §453A(d)).

The net debt proceeds are the gross amount of the debt minus the direct expenses of getting the debt. The amount treated as a payment is considered received on the later of:

(1) The date the debt becomes secured, *or*

(2) The date the debt proceeds are received (§453A(d)).

A debt is secured by an installment obligation to the extent that payment of principal or interest on the debt is directly secured under the terms of the loan, or any underlying arrangement, by any interest in the installment obligation (§453A(d)(4)).

Limit on Payment Treatment

The amount treated as a payment on the pledged installment obligation cannot be more than the excess of:

(a) The total contract price of the installment sale, *over*

(b) Any payments received on the installment obligation before the date the amount is treated as a payment (§453A(d)(2)).

Exception

The pledge rule does not apply if the debt is incurred after December 17, 1987, to refinance a debt that was:

(a) Outstanding on December 17, 1987, *and*

(b) Secured by that installment sale obligation on that date and at all times thereafter until the refinancing.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt if the refinancing is provided by a person other than the creditor or a person related to the creditor (PL 100-647, §6031(c)).

This exception applies only to the amount of the refinancing that does not exceed the principal amount of the original debt immediately before the refinancing. Any excess amount is treated as a payment on the installment obligation (PL 100-647, §6031(b)).

Escrow Accounts

In some cases, the sales agreement, or a later agreement, may call for the buyer to establish an irrevocable escrow account out of which the remaining installment payments (including interest) are to be made. Generally, these sales may not be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, the seller no longer relies on the buyer for the rest of the payments, but on the escrow arrangement (R.R. 73-451; R.R. 77-294).

Escrowed Funds

R.R. 73-451: An agreement where the buyer deposits the purchase price in escrow to be released to the seller in installments constitutes payment in the year of sale and §453 doesn't apply. See also Oden v. Commissioner, 56 T.C. 569 (1971) for use of certificates of deposit.

R.R. 77-294: Substitution of an escrow deposit for a deed of trust as collateral in an installment sale represents payment unless the deposited funds are subject to a substantial restriction.

Reed v. Commissioner, 83-2 U.S.T.C Par. 9728 (C.A. 1,1983): Amazingly, the Reed decision has held that deferred payment through an escrow account is effective to delay income recognition where (1) the escrow arrangement is an arms-length agreement, (2) the taxpayer receives no present economic benefit from the escrowed funds, and (3) the escrowee is not the taxpayer's agent.

Example

Dan sells property for $10,000. The sales agreement calls for a downpayment of $1,000 and payment of $1,500 in each of the next 6 years to be made from an irrevocable escrow account containing the balance of the purchase price plus interest. Dan may not report the sale on the installment method because the full purchase price is considered received in the year of sale. Dan must report all his gain in the year of sale.

Escrow Established In a Later Year

If the seller makes an installment sale and in a later year an irrevocable escrow account is established to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation. Therefore, the seller cannot use the installment method to report any payments they receive from the escrow account. This is because a disposition has occurred (R.R. 77-294).

Substantial Restriction

If an escrow arrangement imposes a substantial restriction on the seller's right to receive the sale proceeds, the sale may be reported on the installment method, provided it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the buyer, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the buyer (R.R. 79-91).

Example

Dan sells his business, including all of its assets, for $50,000. The sales agreement provides for a downpayment of $8,000 and payments of $7,000 in each of the next 6 years to be made from an irrevocable escrow account. The sales agreement also provides that Dan, the seller, will not enter a competing business for a period of 6 years. If at any time during this period Dan enters a competing business, he will forfeit all rights to the amounts then held in escrow. In this situation, the escrow arrangement imposes a substantial restriction and Dan can use the installment method.

Recapture

Under prior law, when an installment sale produced income subject to the recapture of depreciation rules, all gain in each installment payment was treated as ordinary income until all recapturable income was reported. As a result of the TRA '84, the installment method is not allowed for such income.

Thus, an installment sale of depreciable real property could result in full recognition of the §1245 or §1250 recapture in the year of the sale. This occurs even if no principal payments are received in that year (§453(i)).

If a taxpayer sells on the installment method property for which they claimed depreciation deductions, any depreciation recapture income is reported in the year of sale. If the amount of gain equals or is less than the recapture income, the seller does not have an installment sale. Any gain that is more than the recapture income can be reported on the installment method.

To figure the seller's gross profit on the installment sale, add the selling expenses paid on the sale, and the depreciation recapture income reported in the year of sale to the seller's adjusted basis. Then subtract the adjusted basis, as increased, from the selling price to determine the gross profit on the sale (§453(i)).

Installment Sale Worksheet

Part I - Gross Profit

1. Sales Price	$_____	
Less:		
2. Adjusted basis of property sold	$_____	
Less:		
3. Selling expenses	$_____	
Equals:		
4. Gross profit		$_____

Part II - Contract Price

5. Cash downpayment	$_____	
Plus:		
6. Fair market value of other property received	$_____	
Plus:		
7. Face value of purchaser's note	$_____	
Plus:		
8. Excess of assumed mortgage over adjusted basis	$_____	
Equals:		
9. Contract price		$_____

Part III - Gross Profit Percentage

10. Divide item 4 by item 9

_____%

Part IV - Payments Received in Year of Sale

11. Cash downpayment	$_____	
Plus:		
12. Fair market value of other property received	$_____	
Plus:		
13. Principal payments on purchaser's note	$_____	
Plus:		
14. Excess of assumed mortgage over adjusted basis	$_____	
Equals:		
15. Payments in year of sale		$_____

Part V - Recognized Gain

16. Payments received in year of sale (item 15)	$_____	
Times:		
17. Gross profit percentage (item 10)	X_____	
Equals:		
18. Recognized gain		$_____

Imputed Interest & OID

When property is sold and the proceeds are payable in installments, part may be treated as interest. In all types of installment sales, part of the deferred payments is treated as interest if either no interest or a low interest rate is provided.

Complexity

The unstated interest rules for installment or deferred payment sales are covered by two separate but interrelated tax concepts - *imputed interest* and *original issue discount* (OID). Each concept deals with different types of transactions. Section 483 explains the rules on imputed interest on certain deferred payments. Section 1271 et seq. covers the original issue discount rules and applies to deferred payments not subject to §483.

Sale at a Loss

The rules for imputing interest apply even if the property is sold at a loss, or would be sold at a loss when the interest element is separated from the contract amount.

Section 483 - Imputed Interest

Section 483 is applicable (and the OID rules of §1271 et seq. are not applicable) to sales of:

(1) Farms (if the sale price does not exceed $1 million),

(2) A principal residence, or

(3) Any sale for less than $250,000 in principal and interest payments (§1274(c)(4)).

In such cases, the imputed interest rules of §483 apply to any payment which is due more than 6 months after the sale or exchange but only if (1) some or all the payments are due more than 1 year after the sale or exchange and (2) there is some "unstated interest" (that is, the sum of the payments due under the contract exceeds the present value of the payments *and* interest due, if any, under the contract). The present value of the payments is calculated using a discount rate equal to the "applicable federal rate" explained below.

Exemptions

The following payments are exempt from the §483 imputed interest rules:

(1) For a transfer of patents, payments contingent on the productivity, use, or disposition of the patents;

(2) For contracts with separately stated carrying charges, payments treated under §163(b) as if they included interest (this rule only affects the buyer);

(3) Payments due under a debt instrument to which the OID rules (§§1271 through 1274) apply;

(4) Payments if the sales price at the time of the sale or exchange cannot exceed $3,000;

(5) Payments contingent on the life expectancy of one or more individuals and constituting an annuity;

(6) The property is neither a capital nor §1231 asset (only affects the seller).

Imputed Interest Rates

The interest rate imputed to the installment sale is tied to the rates that the federal government pays on its debt (e.g., T-bills) of varying maturity and is called the "applicable federal rate" (AFR). There is a short-term rate (for obligations up to three years), a mid-term rate (three to nine years), and a long-term rate (over nine years). These rates are computed and announced monthly by the IRS. Unless the obligation calls for interest at least equal to the AFR, interest is imputed at that rate.

Small Transaction Exception

For sales of property (other than new §38 property) where the principal amount of the debt instrument is $2,800,000 or less, as adjusted for inflation (R.R. 2018-11), the imputed interest rate shall not exceed nine percent. Thus, the interest rate in such cases is the lower of the AFR or 9% (§1274A(b)).

Intra-family Land Exception

The imputed interest rate cannot exceed six percent on land sales between family members (up to $500,000 per sale). [§483(e)]

Timing

Under §483, the interest imputation occurs as payments are made as if the parties were on the *cash* method. Thus, if §483 is applicable, part of each installment payment will be treated as additional or imputed interest, rather than principal, at the time of payment.

Sections 1271-1274 – Original Issue Discount (OID)

If §483 is not specifically applicable to the installment sale, the OID rules of §§1271 through 1274 apply.

OID Rates

As a general rule, the OID provisions provide for the same rates of interest as §483 (see above), including the small transaction exception.

Timing

Under §1274, OID is imputed as if the parties were on the *accrual* method. Each year, OID is interest income to the seller and deductible to the buyer regardless of whether any payments of principal are made that year.

Cash Method Debt Instrument Exception

In the case of sales of property for $2,000,000 or less, as adjusted for inflation (R.R. 2018-11), if both buyer and seller agree, OID can be accounted for under the cash method rather than the accrual method even though §1274 is applicable rather than §483 (§1274A(c)(2)(A)).

Computation of OID

Start with the sum of the principal payments due under the contract. Subtract the sum of the present values of the principal and interest payments (if any) due under the contract. The present value is determined by discounting the stream of payments at the AFR (or the lower of 9%, if applicable). This is called the "imputed principal amount." The imputed principal amount constitutes the amount realized (see §1001) and will be the buyer's basis for the property. Now, subtract the imputed principal amount from the stated principal amount of the note or contract. This difference is OID and must be included in the seller's income (in addition to the stated interest, if any, under the contract) and will be an additional deduction for the buyer.

Personal Use Property - Buyer's Deduction of Imputed Interest

In the case of "personal use property," the imputed interest rules do not apply to the *buyer* (thus giving him or her *no* deductions for imputed interest) -only to the *seller.* For this purpose, "personal use property" means property that the *buyer* will not use in business or for investment (§1275(b)). This limitation is applicable to transactions subject to either §483 or the OID rules of §1271 et seq.

Repossession

Where the future market value of the property is doubtful, installment sales should be approached with caution. Upon sale, the note that the seller will receive pursuant to the installment sale will be a "purchase money" mortgage and in the event of default, he or she may, under some state laws, be unable to obtain

a deficiency judgment against the buyer. His or her only recourse may be to take the property back.

Section 1038 - Repossession by Seller

No loss is recognized and no bad debt deduction is allowed when real property is repossessed by the seller to satisfy a purchase obligation. Recognized gain on repossession cannot be more than the gain on the original sale, less repossession costs and gain previously reported as income. The excess of cash and the fair market value of other property (except the buyer's obligation) over the gain on the original sale previously reported as income is the measure of the gain recognized.

> **Note:** Any interest payments, stated or imputed, are not counted in figuring the sales price or gain on the original sale. The interest is not considered money or property received on the sale.

The basis of the repossessed property is the adjusted basis of the obligations (including the basis of unsatisfied obligations) as of the date of repossession, plus any repossession gain and cost.

Repossession of Principal Residence

If the property repossessed was the taxpayer's residence, and some or all of the original gain was excluded or not recognized special rules apply. If the property is not resold within a year after repossession, the rules above apply. If it is resold within the year, in effect the repossession is disregarded and the resale is considered a sale of the property occurring on the original sale date.

Repossession on Installment Sale Method - §1038

Part I

Computation of Gain on Original Sale

Consideration Received

1. Cash Down	$_____	
2. Existing Encumbrance	$_____	
3. Purchase Money Trust Deed	$_____	
4. FMV of Other Property	$_____	
5. Total Sale Price	$_____	
Less:		
6. Expense of Sale	$(_____)	
7. Adjusted Sales Price	$_____	
Less:		
8. Adjusted Basis of Property	$(_____)	
9. Realized Gain		$_____

Contract Price

10. Down Payment (Line 1) $_____
11. Purchase Money Trust Deed (Line 3) $_____
12. FMV of Other Property (Line 4) $_____
13. Excess of Mortgage over Basis (Line 2 less 7 plus 8) $_____
14. Total contract Price $_____

Gross Profit Ratio

15. Realized Gain (Line 9) $_____
16. Divided by Contract Price (Line 14) $_____ = _____%

Summary of Reported Gain

		Gross Profit Percentage	Reported Gain
17. 20___ Initial Payments in Year of Sale[1]	$_____	_____%	$_____
18. 20___ Payments on Principal	$_____	_____%	$_____
19. 20___ Payments on Principal	$_____	_____%	$_____
20. 20___ Payments on Principal	$_____	_____%	$_____
21. 20___ Payments on Principal	$_____	_____%	$_____
22. 20___ Payments on Principal	$_____	_____%	$_____
23. Total Payments Received	$_____		
24. Total Gain Reported			$_____

Part II
Computation of Repossession Gain under General Rule

Amounts Received with Respect to the Sale

1. Total Amount Received Directly by Seller $_____
2. Amount Received on Sale of Purchaser's Indebtedness $_____
3. Payments Made on Mortgage by Purchaser for Seller's Benefit $_____
4. Other Amounts _____ $_____
5. Total Amount Received $_____

Gain Returned As Income

6. Gain Reported as Income (Part I, Line 24) $_____
7. Gain Reported on Sale of Notes $_____
8. Total Gain Reported $_____
9. Gain before Limitation (Line 5 less 8) $_____

[1] Line 17 includes (1) cash down payment, (2) payments on principal during the year, (3) fair market value of other property, and (4) excess of mortgage over basis.

Limitation on Gain

10. Sales Price (Part I, Line 5)	$_____	
Less:		
11. Expenses of Sale (Part I, Line 6)	$(_____)	
12. Adjusted Basis of Property (Part I, Line 8)	$(_____)	
13. Net Gain Realized		$_____
Less:		
14. Reported Gain (Part II, Line 8)	$_____	
15. Additional amounts Paid or Transferred Upon Reacquisitions		
A. Payments to Purchaser or Other Persons	$_____	
B. Payments to Reacquire Purchaser's Notes	$_____	
C. Assumption by Seller of Purchaser's Indebtedness Which Arose After Original Sale	$_____	
D. Advances by Seller on Indebtedness	$_____	
E. Payments by Seller on Taxes, Insurance, Etc.	$_____	
F. Foreclosure Costs, Legal Fees, Etc.	$_____	
16. Total (Lines 14 through 15F)		$_____
17. Limitation of Gain[2] (Line 12 less 16 - but not less than zero)		$_____
18. Gain on Repossession - Lesser of (A) or (B)		$_____

Part III

Determination of Basis for Reacquired Property

1. Original Selling Price (Part I, Line 5)	$_____	
Less:		
2. Existing Encumbrances (Part I, Line 2)	$_____	
3. Contract Price	$_____	
4. Payments Received (Part I, Line 23)	$_____	
5. Unsatisfied Debt (Line 3 minus Line 4)	$_____	
6. Reduction of Debt of Unreported Gain:		
A. Profit Ratio (Part I, Line 15)	_____%	
7. Unreported Gain (Line 6A times Line 5)	$_____	
8. Basis of Unsatisfied Debt (Line 5 less 7)		$_____

Increased By:

9. Repossession Gain (Part III, Line 18)	$_____	
10. Payments to Purchaser or Others	$_____	
11. Payments to Reacquire Purchaser's Notes	$_____	
12. Assumption by Seller of Purchaser's Indebtedness	$_____	
13. Advances by Seller on Indebtedness	$_____	
14. Payments by Seller on Taxes, Insurance, Etc.	$_____	
15. Foreclosure Costs, Legal Fees, Etc.	$_____	
16. Total (Line 9 through 15)		$_____
17. Basis of Repossessed Property (Line 8 plus 16)		$_____

[2] If Line 17 is a negative amount enter zero. As a result, Line 18 will also be zero.

Proof of Basis

Adjusted Basis of Property (Part I, Line 8)		$_____
Add:		
Selling Expenses (Part I, Line 7)	$_____	
Gain Previously Reported (Part II, Line 8)	$_____	
Gain on Repossession (Part II, Line 18)	$_____	
Additional Amounts Paid or Transferred (Part II, Line 15a - 15F)	$_____	
Total		$_____
Less:		
Money and Property Received (Part II, Line 5)		$(_____)
New Basis		$_____

Related Party Sales

The related party rules of §453 create a superstructure of provisions and exceptions which override basic installment planning.

Sale of Depreciable Property

If a taxpayer sells depreciable property to certain related persons, they may not report the sale using the installment method. Instead, all payments to be received are considered received in the year of sale. Depreciable property for this rule is any property that can be depreciated by the person or entity to which the taxpayer transferred it (§453(f)(7); §453(g)(1)).

Thus, if a taxpayer disposes of depreciable property to a spouse or an 80% controlled partnership or corporation, within the meaning of §1239(b), all payments to be received are deemed received in the year of sale (§453(g)).

> **Note:** For purposes of defining an 80% owned entity, the constructive ownership rules of §318 apply, except that family members include only the individual's spouse and the 50% limitation of §318 is increased to 80%.

Payments to be received include the total of all payments that are not contingent and the fair market value of any payment that is contingent as to amount (§453(f)(8)).

For any payments which are contingent as to amount but for which the fair market value is not reasonably ascertainable, the basis is recovered ratably and the purchaser may not increase the basis of any property acquired in the sale by any amount before the time the seller includes the amount in income (§453(g)(1)(B); §453(g)(1)(C)).

Exception

This rule will not apply to a sale if no significant tax deferral benefits will be derived from the sale or the taxpayer can show, to the satisfaction of IRS, that avoidance of federal income taxes was not one of the principal purposes of the sale (§453(g)(2)).

Resale Rule

There is a special rule when a seller makes a first disposition (sale or exchange) of property under the installment method to a related person who then makes a second disposition (sale, exchange, gift, or cancellation of installment note):

(1) Before making all payments on the first disposition, *and*

(2) Within 2 years of the first disposition.

In such a case, the seller treats part or all of the amount the related person realizes (or the fair market value if disposed property is not sold or exchanged) from the second disposition as if the seller received it from the first disposition at the time of the second disposition (§453(e)(1); §453(e)(2)(A)).

Thus, where the seller sells real property to a related person, on a deferred payment basis, and the related person resells the property for cash (or even better terms) within two years, the original seller is treated as if he or she received the cash for purposes of accounting under the installment method (§453(e)).

For marketable securities, the rule applies without time limit to resales made before the installment obligation is fully paid. In addition, the two-year period is suspended for any period that the installment buyer's risk of loss is substantially diminished by such things as holding a put or option, or short sale (§453(e)(2)).

The effect of these rules is to prevent related taxpayers from using the installment sales method to avoid current tax on an asset's appreciation.

Example 1

In 2023, Harvey sold farmland to his son Bob for $500,000, which was to be paid in five equal payments over 5 years, plus adequate stated interest on the balance due. Harvey's installment sale basis for the farmland was $250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50% (his gross profit of $250,000 divided by the contract price of $500,000). Harvey received $100,000 in 2023 and included in his income for that year $50,000 ($100,000 x 0.50). Bob made no improvements to the property and in 2024 sold it to Alfalfa Inc. for $600,000. This is the amount realized from the second disposition. Harvey figures his installment sale income for 2024 as follows:

Amount realized on second disposition or

contract price on first disposition, whichever is less	*$500,000*
Minus: Sum of payments from Bob in 2023 and 2024	*200,000*
Amount treated as payment because of second disposition	*$300,000*
Add: Payment from Bob in 2024	*100,000*
Total payments received and treated as received for 2024	*$400,000*
Multiply by gross profit percentage	*.50*
Installment sale income for 2024	*$200,000*

Harvey will not include in his income from installment sales any principal payments he receives on the installment obligation for 2025, 2026, and 2027 because he has already reported the entire amount of the payments from the first disposition of $500,000 ($100,000 in 2023 and $400,000 in 2024).

Example 2

The facts are the same as in the previous example except that Bob sells the property for only $400,000. The gain for 2024 is figured as follows:

Amount realized on second disposition or contract price on first disposition, whichever is less	*$400,000*
Minus: Sum of payments from Bob in 2023 and 2024	*200,000*
Amount treated as payment because of Second disposition	*$200,000*
Add: Payment from Bob in 2024	*100,000*
Total payments received and treated as received for 2024	*$300,000*
Multiply by gross profit percentage	*.50*
Installment sale income for 2024	*$150,000*

In 2025 Harvey receives a payment of $100,000 from Bob which is not taxed. It is considered to be recovered tax-free because Harvey already reported the payment and gain in 2024 as the result of the $200,000 which he treated as a payment even though he did not actually receive it. He applies the $100,000 payment in 2025 against this amount. He is also not taxed on the payment he receives in 2026 and he applies the payment against the $200,000 he treated as payment in 2024. In 2027, he receives the final $100,000

payment. He figures the amount of gain he must recognize in 2027 from the installment sale as follows:

Sum of payments actually received as of the end of 2027 from the first disposition		*$500,000*
Minus the sum of:		
Payment from 2023	*$100,000*	
Payment from 2024	*100,000*	
Amount treated as payment in 2024	*200,000*	
Total of amounts on which gain was previously recognized		*400,000*
Amount of payment on which gain is to be recognized for 2026		*$100,000*
Multiply by gross profit percentage		*.50*
Installment sale income for 2027		*$ 50,000*

Related Persons

Spouses, children, grandparents, and parents, but not brothers and sisters, constitute related persons. A corporation is related if its stock would be attributed to the other party under the attribution rules of §318.

Exceptions

Several major exceptions exist to the above resale rule:

(1) A non-liquidating installment sale of stock to the issuing corporation,

(2) An involuntary conversion, if the initial sale occurred before the threat or eminence of conversion,

(3) A second disposition after the death of the installment seller or buyer, and

(4) Any transaction that does not have a tax avoidance purpose.



Review Questions

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3. The original issue discount (OID) rules apply in cases where §483 fails to apply to a §453 installment sale. Under the OID rules of §§1271 through 1274, what is the imputed principal amount?

a. It is the amount added to the stated principal amount on the note or contract to get the OID.

b. It is the amount determined by discounting the stream of payments at the AFR.

c. It is the sum of the principal payments due under a contract.

d. It is the purchaser's basis for the property once bought.

4. Under §1038, when a seller repossesses real property to satisfy a purchase obligation, the seller can recognize gain. In this determination, what is excluded from the sales price or gain on the original sale?

a. the buyer's note or mortgage given to evidence the debt.

b. any interest.

c. liabilities of the seller assumed (or taken subject to) by the buyer.

d. the FMV of other property received from the buyer in the transaction.

5. Under the §453 resale rule, when a seller (A) disposes of property under the installment method to a related person (B), and then B disposes of said property within two years and before he or she makes all payments, A must treat a portion or all of the amount realized by B as if A received it from the initial disposition. Under which of the following circumstances would this resale rule apply?

a. a non-liquidating installment sale of stock to B who is the issuing corporation.

b. B disposes of property after the death of A or B.

c. an involuntary conversion, if A initially disposed of the property after the threat or eminence of conversion.



Like-Kind Exchanges

If a taxpayer trades their property for other property of the same kind, they can often postpone reporting part of the gain. These trades are known as “like-kind exchanges.” The property received in a like-kind exchange is treated as if it were a continuation of the property given up.

In a like-kind exchange, a taxpayer does not have to report any part of their gain if they receive only like-kind property. However, if money or other property is al-

so received, gain must be reported to the extent of the money or the fair market value of the other property received (§1031).

Installment Payments

If, in addition to like-kind property, a taxpayer receives an installment obligation in the exchange, the following rules apply:

(1) The contract price does not include the fair market value of the like-kind property received in the trade;

(2) The gross profit is reduced by any gain on the trade that can be postponed; and

(3) Like-kind property received in the trade is not considered payment on the installment obligation (§453(f)(6)(C)).

Example

In 2023, George trades property with an installment sale basis of $400,000 for like-kind property having a fair market value of $200,000. He also receives an installment note for $800,000 in the trade. Under the terms of the note, he is to receive $100,000 (plus interest) in 2024 and the balance of $700,000 (plus interest) in 2025.

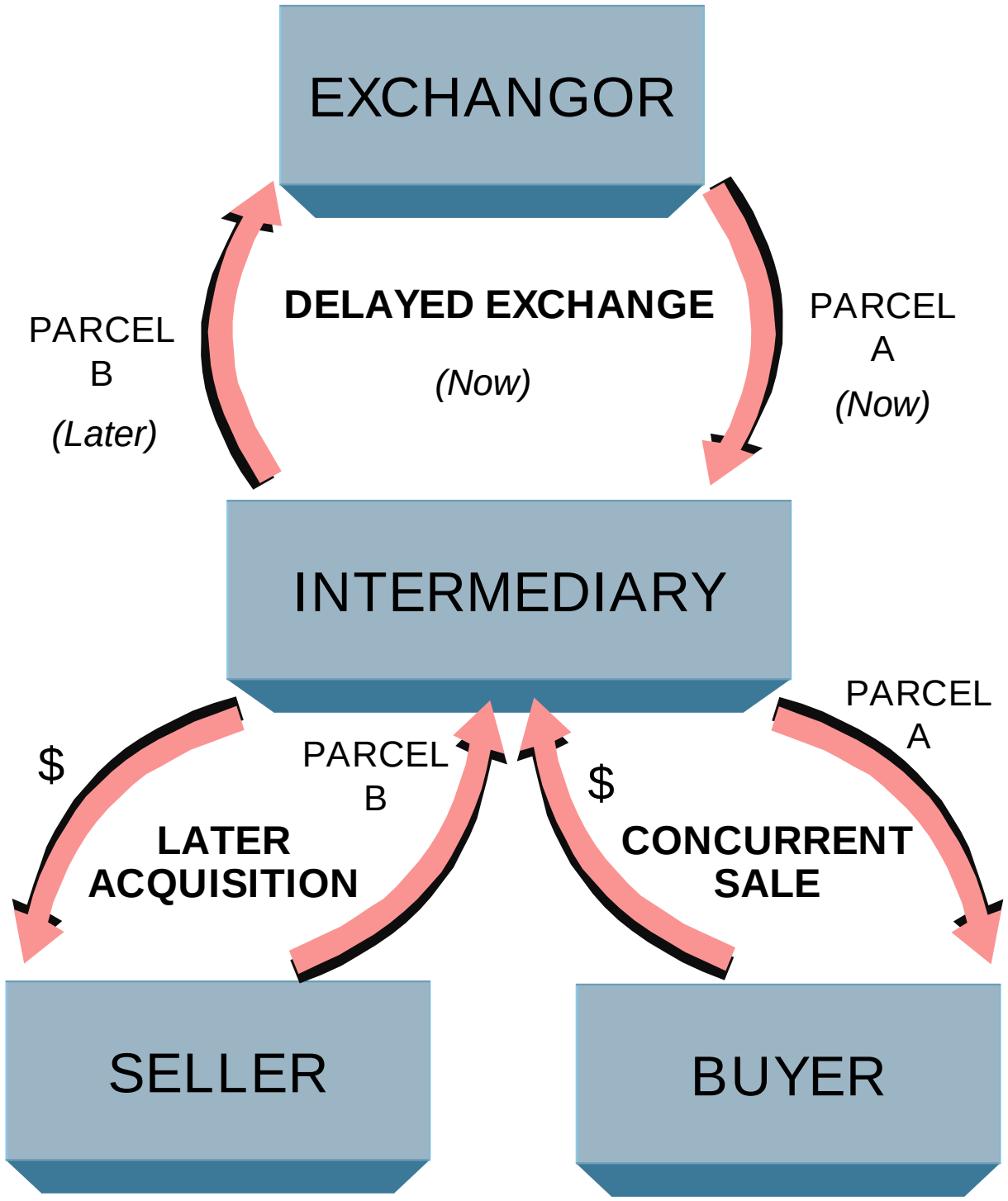
George's gross profit is $600,000 (selling price of $1,000,000 minus $400,000 installment sale basis). The contract price is $800,000 ($1,000,000 minus the fair market value of the like-kind property received, $200,000). The gross profit percentage is 75% ($600,000 divided by $800,000). He reports no gain in 2023 because the like-kind property he receives is not treated as payment for figuring gain. He reports $75,000 gain for 2024 (75% of $100,000) and $525,000 gain for 2025 (75% of $700,000).

Final Regulations & Delayed Exchanges

In a delayed exchange, the taxpayer typically transfers property to an intermediary who promises to sell the original property, acquire replacement property, and transfer it to the taxpayer. To ensure that such an arrangement does not result in actual or constructive receipt of funds or an agency relationship that might cause the transaction to be treated as a taxable sale, Regulation §1.1031(k)-1(g) provides certain safe harbors. When a taxpayer uses these safe harbors, they are not considered to be in actual or constructive receipt of money or other property held by the intermediary.

Note: The IRS uses the term "deferred exchange" to define what most real estate exchangors call a "delayed exchange."

Delayed Exchange Format



Subject to other requirements of the installment sale rules under §453, if the taxpayer uses the safe harbors of the delayed exchange regulations, they are entitled to report installment gain recognized on the delayed exchange under the installment method of tax reporting.

On April 20, 1994, the IRS issued T.D. 8535 containing final regulations under 1031(a)(3) relating to the coordination of deferred like-kind exchanges with the installment sale tools or §453. These regulations are not controversial in nature and quite taxpayer favorable in providing a suspension theory for coordinating §1031 and §453. The suspension theory adopted in the regulations allows for the settling of exchange issues before applying the installment sale rules so long as the exchange was originally entered into with a bona fide intent to be completed. Additionally, the regulations apply installment sales treatment to cash received by an exchangor at the end of the exchange period or the identification period (if no identification has been made) if cash is received in a subsequent tax year.

> **Note:** The final regulations clarify that a taxpayer will be treated as having a bona fide intent only if it is reasonable to believe, based on all the facts and circumstances as of the beginning of the exchange period, that like-kind replacement property will be acquired before the end of the exchange period (Reg. §1.1031(k)-1(j)(2)(iv))

Thus, under the new rules, if a taxpayer uses the deferred exchange safe harbors, including the use of a qualified intermediary, they will not have constructive receipt of installment payments, if, at the beginning of the exchange period, the taxpayer has a bona fide intent to enter into a delayed exchange.

These final regulations are effective April 20, 1994, however, taxpayers may choose to apply the regulations retroactively to transfers of property on or after May 16, 1990, if the transfer or property otherwise meets the requirements for a like-kind exchange under the rules then in effect.

The new regulations provide that, for installment sale purposes, the determination of whether payment has been received or not will be made without regard to the fact that qualified escrow accounts, qualified trusts, or qualified intermediaries have been used. Thus, subject to the other requirements of §453, taxpayers who use the safe harbors of the existing like-kind exchange regulations will be entitled to report any gain recognized on the delayed exchange under the installment method.

Example

Dan owns unencumbered real estate worth $100,000 that qualifies for a like-kind exchange under §1031 and has an adjusted basis of $30,000. On September 23, 2023, Dan enters into a delayed exchange agreement with a qualified intermediary and transfers his property to that intermediary. The in-

termediary then transfers Dan's original property to a buyer for $100,000 in cash. On March 11, 2024, the intermediary acquires replacement property with a fair market value of $75,000 and delivers it to Dan along with the balance of $25,000. Dan's recognized gain is limited to the $25,000 cash boot received. Any agency relationship between Dan and the qualified intermediary is disregarded for purposes of the installment sale rules. Dan is treated as receiving the cash payment on March 11, 2024, and not on September 23, 2023 Thus, under the installment method, Dan may report the $25,000 gain in 2024.

The new rules also apply to a transaction that ultimately fails to qualify as a like-kind exchange under §1031. In such a failed exchange, the regulations provide that a person who otherwise satisfies the definition of a qualified intermediary is not treated as the taxpayer's agent even if that person ultimately fails to acquire replacement property and transfer it to the taxpayer.

Example

Dan transfers his apartment building to a qualified exchange intermediary in 2023. The intermediary sells the property to a waiting buyer and holds the funds until Dan can identify a replacement property. Dan properly identifies a new property within 45 days but is unable to close the exchange within the required 180 days. Since the exchange failed, the intermediary hands Dan, in 2024, all of the cash it held from the sale of the old property. Because Dan always intended to exchange, the sale is reported in 2023 but the gain is taxable as an installment sale with proceeds received in 2024.

Another requirement of installment sale treatment is that the seller must receive the installment note from the buyer. Receipt of a note from a person other than the person acquiring the property is treated as a payment in the year of sale under §453. Addressing this problem, the regulations provide a special rule.

For installment sale purposes, the receipt by a taxpayer of an installment note of the qualified intermediary's transferee is treated as the receipt of indebtedness of the person acquiring the taxpayer's relinquished property. Thus, the receipt of the installment note will not be considered a payment under §453. This rule also applies to simultaneous exchanges (IRS Pub. 537; Reg. §1.1031(b)-2(b)).

Example

Dan owns unencumbered real estate worth $100,000 that qualifies for a like-fried exchange under §1031 and has an

adjusted basis of $30,000. On September 22, 2023, Dan enters into a delayed exchange agreement with a qualified intermediary and transfers his property to the intermediary. The intermediary then transfers the property to a buyer for $80,000 in cash and the buyer's 10-year installment note for $20,000. On March 11, 2024, the intermediary acquired replacement property with a fair market value of $75,000, which the intermediary delivered to Dan along with the installment note of $20,000 and the $5,000 cash balance. Under installment note rules, the note is treated as taxable boot in the amount of $20,000. However, the receipt of this note is treated as an obligation of the person buying Dan's property and not as a note from the intermediary. Thus, the receipt of the note is not a payment and qualifies for reporting under the installment method as payments on the note are received from the buyer. The $5,000 cash boot is recognized as gain on the day it is delivered to Dan by the intermediary in 2024.

Finally, the IRS stated that the following issues were still open and might be the subject of future guidance:

1. Deferred exchanges of multiple assets.

2. The tax consequences of a qualified intermediary's disposition of a note to a third party during the exchange period.

3. The tax treatment of principal payments made on an installment note during the exchange period.

4. The tax consequences of making the installment note payable to a qualified intermediary.

5. The tax treatment of a reversion to the transferee of cash held in a qualified escrow account or qualified trust followed by the transferee's issuance of an installment note to the taxpayer at the end of the exchange period.

Contingent Payments or Price

Formerly installment reporting of gain from deferred payment sales was not available where all or a part of the selling price was subject to a contingency. Prior law required that the selling price had to be fixed and determinable in order to benefit from installment reporting. The seller had to recognize all of the gain in the year of sale, even though some or all of the payments were to be made in future years.

Installment Sales Revision Act of 1980

The Installment Sales Revision Act of 1980 drastically revised the installment sales rules as they apply to sales of reality and casual sales of personal property

(i.e., nondealer sales). A major alteration of prior law is the application of §453 to any sale, the price of which is subject to a contingency. Section 453(i)(2) delegated to the Treasury the authority to promulgate regulations providing for a ratable basis recovery in transactions when the gross profit or the total contract price, or both, cannot be readily ascertained. S Rep No. 1000, 96th Cong, 2d Sess (1980), reprinted in 1980 US Code Cong & Ad News 4717.

Contingent Payment Sale

Regulation §15A.453-1(c)(1) deals with contingent price sales. A "*contingent payment sale*" is defined as a sale or other disposition of property in which the selling price cannot be determined by the close of the year in which such sale or other disposition occurs.

These regulatory rules generally provide for methods of allocating the taxpayer's basis (including selling expenses) to payments received and to be received in such a contingent price sale. The rules describe the following contingent payment transactions:

(1) Sales on which maximum selling price is determinable;

(2) Sales in which a maximum selling price is not determinable, but the payment period is fixed or determinable; and

(3) Sales in which neither a maximum selling price nor a definite payment term is determinable.

Maximum Selling Price Transactions

If under the terms of the sales agreement, the maximum amount of sales proceeds that a taxpayer can receive can be determined as of the end of the taxable year in which the sale or other disposition occurs, the contingent payment sale will be treated as having a maximum selling price. In determining the selling price, all contingencies contemplated by the agreement will be assumed met or otherwise resolved in a manner that maximizes the selling price and accelerates payments to the earliest date or dates as set forth in the agreement. The taxpayer's basis shall be allocated to payments received and to be received by treating the maximum selling price as the "selling price" for purposes of §453 (IRS Pub. 537; Reg. §15A.453-1(c)(2)(i)(A)).

Recomputation

If this maximum amount is subsequently reduced, the selling price, gross profit, contract price, and gross profit ratio must be recomputed with respect to payments received in or after the taxable year in which the event requiring such reduction occurs (IRS Pub. 537; Reg. §15A.453-1(c)(2)(i)(A)). Moreover, if interest is not included in the computation of the maximum price under the sales arrangement, the selling price will be reduced to take into ac-

count the fact that part of each payment reflects interest (IRS Pub. 537; Reg. §15A.453-1(c)(2)(ii)).

The Regulations give the following example (IRS Pub. 537; Reg. §15A.453-1(c)(2)(i)(B)):

Example

Example 2: C owns Blackacre, which is encumbered by a long-standing mortgage of $100,000. On January 15, 1981, C sells Blackacre to D under the following arrangement: $100,000 in cash on closing; nine equal annual installment payments (the first to be made on March 30, 1982), equal to five percent of the gross annual rental receipts from Blackacre generated during the preceding calendar year. Each deferred payment is accompanied by a payment of interest calculated at the rate of 12 percent per annum. The maximum amount payable to C under the agreement (exclusive of interest) is set at $2,100,000. D, the purchaser, also agrees to assume the existing mortgage. C's basis (including selling expenses) in Blackacre is $300,000.

Given the foregoing facts, the selling price of Blackacre is $2,100,000 (the maximum selling price set forth in the agreement). The contract price is $2,000,000 (selling price of $2,100,000 less the $100,000 existing mortgage). Gross profit is $1,800,000 ($2,100,000 less $300,000 basis). The gross profit ratio is, therefore, nine-tenths (gross profit of $1,800,000 divided by $2,000,000 contract price). Therefore, of the $100,000 cash payment received by C in 1981, $90,000 is gain on the sale of Blackacre and $10,000 is C's basis recovery amount.

Fixed Payment Term Transactions

If there is no maximum price set in the agreement, but there is a fixed term over which payments are to be received by the seller, the taxpayer's basis (inclusive of selling expenses) is to be allocated to the taxable years in which payment may be received in equal annual amounts. In this situation, interest set forth in the agreement is irrelevant (IRS Pub. 537; Reg. §15A.453-1(c)(3)(i)).

Losses

If in any taxable year, the amount of the payment received by the seller is less than the amount of basis allocable to that taxable year, no loss is allowed, unless the taxable year is the final year of payment or the obligation is worthless. Any loss not allowed in any given year is added to the unrecovered portion of basis allocable to that year and carried forward to the next succeeding taxable year (IRS Pub. 537; Reg. §15A.453-1(c)(3)(i)).

By way of example, Reg. §15A.453-1(c)(3)(ii), Example 1 states:

Example

A sells Blackacre to B for ten percent of Blackacre's gross yield for each of the next five years. A's basis in Blackacre is $5,000,000. The maximum selling price is not ascertainable, but the payment term is fixed so basis is recovered ratably over the period during which payment may be received by A. This period is five years; therefore, A's basis is allocable $1,000,000 to each of five years. Thus, if A receives a payment in year one of $1,300,000, his gain is $300,000 in that year; if his payment in year two is $1,500,000, he receives $500,000 of gain. If in year three he receives $900,000, he has neither gain nor loss — the amount of basis not recovered, i.e., $100,000, is carried forward to year four and the amount of basis recoverable in that year is increased to $1,100,000.

Transactions with Neither Maximum Selling nor Fixed Payment Term

The regulations provide that arrangements that neither specify a maximum selling price nor set a fixed period over which payments are to be received by the seller are to be closely scrutinized because a question arises as to whether a sale has realistically occurred. If the transaction does qualify as a sale, the basis of the taxpayer (including selling expenses) is to be recovered in equal annual installments over a period of 15 years, commencing with the date of sale (IRS Pub. 537; Reg. §15A.453-1(c)(4)).

Losses

No loss is allowed in any taxable year in which no payment is received or the amount of payment received (exclusive of interest) is less than the basis allocable to that year; rather, that excess basis is reallocated in level amounts over the balance of the 15-year term, and any basis not recovered at the end of the 15th year is carried forward to the next succeeding year and such carryforward is continued thereafter from year to year until all basis has been recovered. Apparently, losses will then be recognized only if and when the payment obligation becomes worthless (IRS Pub. 537; Reg. §15A.453-1(c)(4)).

Income Forecast Method

The regulations provide that, if the property sold or disposed of in the transaction is depreciable property of a type normally eligible for depreciation on the

income forecast method or is depletable property of a type normally eligible for cost depletion in which the total future production must be estimated, and payments under the contingent sales price agreement are based on receipts or units produced by or from the property, the taxpayer may recover his or her basis by using the income forecast method (IRS Pub. 537; Reg. §15A.453-1(c)(6)(i)).

This rule recognizes that there are situations in which the failure to take into account the nature or productivity of the property sold may be expected to result in a distortion of the taxpayer's income over time. Examples of appropriate transactions include cases that meet the foregoing criteria and in which the property sold is a mineral property, a motion picture film, a television film, or a taped television show (IRS Pub. 537; Reg. §15A.453-1(c)(6)(i), (iii)).

Election

This method is to be elected by the taxpayer on its tax return timely filed for the first year under the sales agreement in which a payment is received (IRS Pub. 537; Reg. §15A.453-1(c)(6)(ii)).

The IRS reserves the right to specify other properties of a similar character that will be eligible for basis recovery on the income forecast method. In addition, taxpayers are specifically permitted to seek private letter rulings on whether a specific property qualifies as property of the character eligible for this method of basis recovery (IRS Pub. 537; Reg. §15A.453-1(c)(6)(ii)).

Calculation

The calculation required in the application of this method involves multiplying the taxpayer's basis in the property sold by a fraction, the numerator of which is the payment received (exclusive of interest) in a taxable year and the denominator of which is the forecasted or estimated total payments (exclusive of interest) that are to be received. If in a year subsequent to the year of sale, it is discovered that the income forecast was substantially overestimated or underestimated by circumstances arising in such subsequent year, an adjustment to the method for each subsequent year must be made (IRS Pub. 537; Reg. §15A.453-1(c)(6)(iii)).

Special Rules

If a taxpayer is able to demonstrate before the due date of the return (including extensions) for the taxable year in which the first payment under a contingent payment sales agreement is received that the utilization of any of the foregoing normal basis recovery rules will "substantially and inappropriately defer recovery of basis," he or she may use an alternative method (IRS Pub. 537; Reg. §15A.453-1(c)(7)(ii)).

Qualification

To qualify for any alternative method, a taxpayer must demonstrate:

(1) That the alternative method is a reasonable method of recovering basis ratably; and

(2) That under this method, it is reasonable to conclude that over time he or she likely will recover basis at a rate twice as fast as the rate at which basis would have been recovered under the otherwise required normal basis recovery rule.

In addition, the taxpayer must receive a ruling from the IRS before such an alternative method of basis recovery can be used (IRS Pub. 537; Reg. §15A.453-1(c)(7)(ii)).

If the IRS finds that utilization of a normal basis recovery rule will "substantially and inappropriately accelerate recovery of basis," then it may require the taxpayer to use an alternative method of basis recovery. In order to defeat the IRS in its application of any such alternative method, the taxpayer bears the burden of showing either:

(1) That the IRS's method of basis recovery is not a reasonable method of ratable recovery; *or*

(2) That it is not reasonable to conclude that the taxpayer, over time, is likely to recover basis at a rate twice as fast under the normal basis recovery rule as he or she would recover his or her basis under the alternative method the IRS proposes (IRS Pub. 537; Reg. §15A.453-1(c)(7)(iii)).

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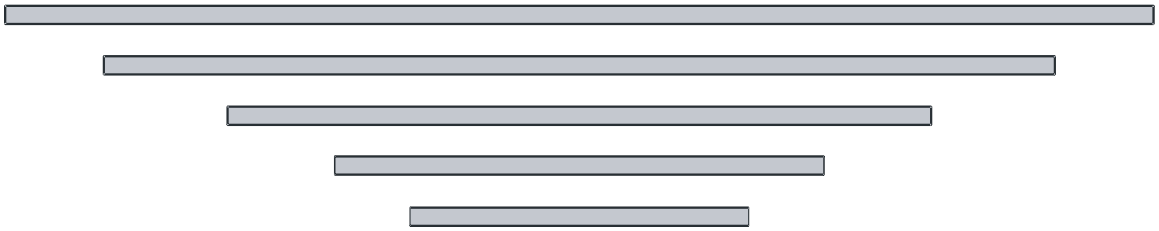
6. The Installment Sales Revision Act of 1980 fundamentally changed the installment method establishing most of its current structure. What is one of the long-standing results of this Act?

a. The installment sale method is not available where the entire selling price is subject to a contingency.

b. The seller can apply §453 to a sale where the price is subject to a contingency.

c. All of the gain from contingent price deferred payment sales must be recognized in the year of sale.

d. In order for the seller to use the installment method, a portion of the selling price has to be fixed and determinable.



Single Sale of Several Assets

If a taxpayer sells two or more assets in a single sale to one buyer and there is more than one class of asset, they must allocate all payments among the different classes of assets in proportion to their respective selling prices (R.R. 68-13).

The arm's-length allocation of the selling price and of payments received in the sale will be accepted if substantiated by all the facts and circumstances. However, an allocation that is not based on the respective selling prices of the assets sold is not acceptable.

If any asset is encumbered by debts assumed by the buyer, or the asset is taken subject to a debt and an arms-length allocation of the downpayment or other payments to be received was not made, the downpayment and payments received from installment obligations should be allocated on the basis of the proportionate net fair market values of the assets. The net fair market value of any asset is its fair market value reduced by any debt the buyer assumes or any debt to which the asset is subject (R.R. 76-110).

A sale of separate and unrelated assets of the same type under a single contract is reported as one transaction for the installment method. However, if an asset is sold at a loss, its disposition may not be reported on the installment method but must be reported separately. The remaining assets sold at a gain are reported together (R.R. 76-110).

Sale of a Business

The installment sale of an entire business, for one overall price under a single contract is not the sale of a single asset. The sale generally includes the sale of real and personal property that can be reported on the installment method and inventory items that cannot be reported on the installment method. The sale of depreciable property cannot be reported on the installment method to the extent the gain is reported in the year of sale because it is depreciation recapture income. Assets sold at a loss cannot be reported on the installment method. The selling price must be allocated to each asset class.

Except for assets exchanged under the like-kind exchange rules, both the buyer and seller of a business must use the *residual method* to allocate the sales price to the various business assets transferred. This method determines the gain or loss from the transfer of each asset.

Residual Method

The residual method must be used for any transfer of a group of assets that continues a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business, or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid. A group of assets constitutes a trade or business if goodwill could, under any circumstances, attach to the assets.

The residual method provides for the sales price to be reduced first by the amount of cash, demand deposits, and similar accounts transferred by the seller. The amount of sales price remaining after this reduction must be allocated among the various business assets in a specified order.

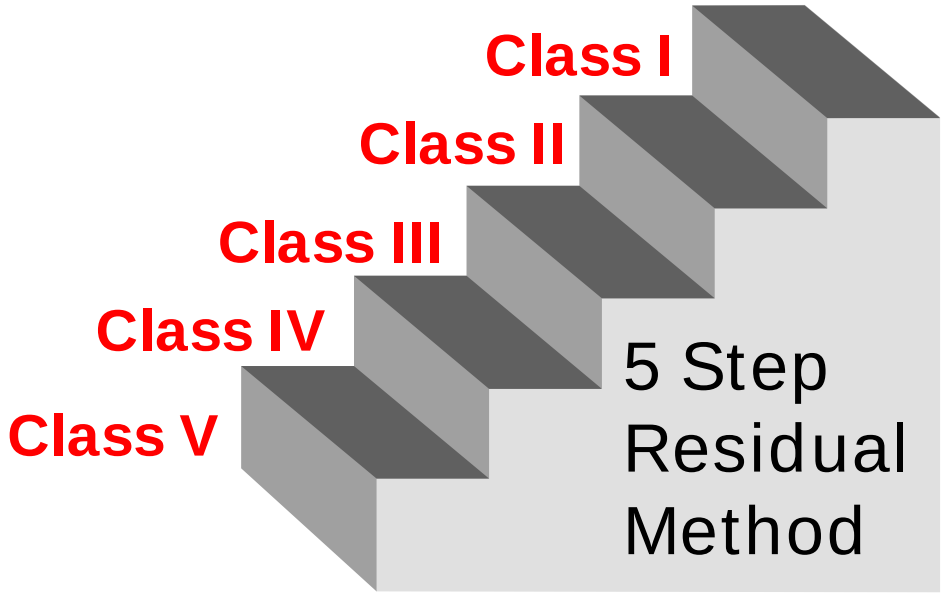
The allocation must be made among the following assets in proportion to (but not in excess of) their fair market value on the purchase date in the following order:

(1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency,

(2) All other assets except §197 intangibles, *and*

(3) §197 intangibles (§1060).

Purchase Price Allocation Regs



Under §1060, the purchase price of a business is allocated to <u>five</u> classes of assets in the following order:

<u>Class I</u> - cash and demand deposits,

<u>Class II</u> - highly liquid assets,

<u>Class III</u> - all assets other than Class I, II, IV or V, both tangibles and non §197 intangibles,

<u>Class IV</u> - § 197 intangibles, except goodwill and going concern value, and

<u>Class V</u> - §197 intangibles of goodwill and going concern value.

How to report

Both the seller and buyer must prepare and attach Form 8594, *Asset Acquisition Statement Under Section 1060*, to their income tax return for the year in which the sale occurred.

Inventory

If inventory items are included in an installment sale, the seller may have an agreement with the buyer concerning which payments are for inventory and which are for the other assets being sold. If there is no agreement, each payment must be allocated between the inventory and the other assets sold.

The sale of inventory items cannot be reported on the installment method. All gain or loss on their sale must be reported in the year of sale, even if the seller is paid in later years.

The amount the seller receives (or will receive) on the sale of inventory items is reported as ordinary business income. The seller's basis in the items is used to figure the cost of goods sold, and the part of the selling expenses allocated to inventory is deducted as an ordinary business expense.

Sale of Partnership Interest

A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. However, the seller must make an allocation if the partnership's assets included unrealized receivables and substantially appreciated inventory items.

Note: Unrealized receivables include depreciation recapture income.

The gain allocated to the recapture income and the substantially appreciated inventory cannot be reported under the installment method. The gain allocated to the other assets can be reported under the installment method.

Dealer Dispositions

The Revenue Act of 1987 repealed the installment method for "dealer dispositions." All payments to be received on a sale of dealer real property are deemed received in the year of sale. What constitutes a dealer disposition will doubtlessly produce intense conflict between the Service and taxpayers.

Definition

Section 453(l)(1)(B) provides that a dealer disposition is any disposition of real property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

Residential Lot & Timeshare Exception

Dealers in certain residential lots and timeshares can continue to use the installment method, but there is a price. Such a dealer must elect to pay interest on the amount of deferred tax attributable to the use of the installment method.

Interest Computation

Under §453(l)(3)(A), interest on the deferred tax is payable only as payments are actually received on the installment obligation. The amount of interest payable is determined by applying the applicable federal rate at the time of sale to the amount of tax attributable to the payments received. No interest is payable on installment payments received in the year of sale (§453(l)(3)(B)(iii)).

Qualification

Under §453(l)(2)(B)(ii)(II), gain on the sale of a residential lot by a dealer qualifies for installment reporting only if the lot is sold to an individual and neither the dealer nor a related person is to make improvements to the lot.

Section 453(l)(2)(B)(ii)(I) provides that gain on the installment sale of a timeshare by a dealer qualifies only if the timeshare is sold to an individual and if it is a timeshare right to use or timeshare ownership interest in residential real property for not more than six weeks per year.

Installment Notes in Excess of $5 Million

Section 453A(a)(1) imposes interest on tax deferred under the installment method to the extent the sum of deferred payments from certain dispositions during any year exceeds $5 million. This provision applies to the disposition of real property used in the taxpayer's trade or business or held for the production of rental income, provided, in either case, the sales price exceeds $150,000 (§453A(b)(1)). This rule does not apply to installment obligations arising from the disposition of personal use property or property that is used or produced in the trade or business of farming (§453A(b)(3)).

Computation of Interest

The amount of interest payable is determined under a three-component formula that requires: (1) the applicable percentage of (2) the deferred tax liability to be multiplied by (3) the underpayment rate.

Definitions

The applicable percentage is determined by dividing (1) the portion of the aggregate face amount of installment obligations outstanding as of the close of the taxable year in excess of $5 million by (2) the aggregate face amount of the installment obligations outstanding as of the close of the taxable year (§453A(c)(4)).

Deferred tax liability is (1) the amount of gain with respect to an obligation that has not been recognized as of the close of the tax year multiplied by (2) the maximum individual or corporate tax rate (whichever is applicable) for the tax year (§453A(c)(3)).

The underpayment rate is the rate effective under §6621(a)(2) for the month with or within which the tax year ends (§453A(c)(2)).

Pledging

Prior to 1988, taxpayers could get significant tax benefits by first selling property on the installment method and then pledging the resulting installment obligations as collateral for a loan. While an outright sale of the installment obligations would have triggered tax under §453B (or §453(d) prior to 1980), the pledge allowed taxpayers to get tax deferral while receiving cash equal to a substantial portion of the selling price of the property. However, the benefits of this technique were eliminated by the 1987 Tax Act, which added §453A to the Code.

Section 453A(d)(1) provides that if an installment obligation is pledged as security for a loan, the net proceeds of the loan are deemed a payment received on the installment obligation. This provision applies to any obligation that arises from the disposition of real property under the installment method if the property was used in either (i) the taxpayer's trade or business or (ii) held by the taxpayer for the production of rental income, provided in either case the sales price of property exceeded $150,000 (§453A(b)(1)). This rule is not applicable to installment obligations arising out of the sale of personal use property such as the taxpayer's home.

Dispositions of Installment Obligations

If a taxpayer disposes of an installment obligation, the entire amount of the gain or loss from that disposition is recognized (§453B). A disposition includes a sale,

exchange, cancellation, bequest, distribution, or transmission of an installment obligation. Generally, a disposition occurs when the rights accruing to the seller under an installment sale either disappear or are materially disposed of or altered so that the need for postponing recognition of gain otherwise realized ceases.

> **Note:** An installment obligation is the buyer's note, deed of trust, or other evidence that the buyer will make future payments.

Gain or Loss

If a taxpayer disposes of an installment obligation, they will usually have a gain or loss to report. The gain or loss is considered to be gain or loss on the sale of the property for which the seller received the installment obligation. If the original installment sale of the property produced ordinary income, the disposition of the obligation will result in ordinary income or loss. If the original sale resulted in a capital gain, the disposition of the obligation will result in a capital gain or loss (§453B(a)).

If the obligation is sold, the gain or loss is the difference between the basis of the obligation and the amount realized. The basis of an installment obligation is the excess of the unpaid balance of the obligation over the income that would be reportable on the unpaid balance if the obligation were paid in full.

The following rules can be used to figure gain or loss from the disposition of an installment obligation:

(1) If a taxpayer sells or exchanges the obligation, or accepts less than face value in satisfaction of the obligation, the gain or loss is the difference between the taxpayer's basis in the obligation and the amount realized (§453B(a)(1)); or

(2) If a taxpayer disposes of the obligation in any other way, the gain or loss is the difference between the taxpayer's basis in the obligation and its fair market value at the time of the disposition (§453B(a)(2)).

> **Note:** This rule applies, for example, when the taxpayer gives the installment obligation to someone else or cancels the buyer's debt.

Exceptions

Increasing the interest rate on an installment obligation and substituting a new obligor is not a disposition of the obligation. There is also no disposition for assigning an installment obligation as collateral for a loan. A transfer of an installment obligation to a financial institution at a discount, or at face value less certain charges, with substantial incidents of ownership relinquished is a disposition.

Substitution

R.R. 74-157: The substitution of two promissory notes, each secured by a deed of trust on a parcel of land, for the original unpaid note and deed of trust for the total land is not a disposition.

R.R. 75-457: The mere substitution and release of the original obligor of an installment obligation, and the assumption of the installment note by a new obligor, without any other changes, will not in itself constitute a satisfaction or disposition of the original note.

Tax-free Transfers

In some cases, installment obligations may be transferred without tax being imposed. These instances include transfers to a controlled corporation in exchange for stock or securities; contributions to a partnership in exchange for an interest in the partnership; distributions in certain corporate liquidations; distributions by a partnership to a partner; and exchanges of property for stock or securities in corporate reorganizations.

Transfers Between Spouses or Former Spouses

No gain or loss is recognized on the transfer of an installment obligation between a husband and wife or a former husband and wife if incident to a divorce (§1041). A transfer is incident to a divorce if it occurs within one year after the date on which the marriage ends, or is related to the end of the marriage. The same tax treatment for the transferred obligation applies to the spouse or former spouse receiving it as it applied to the transferor spouse or former spouse. The basis of the obligation to the transferee spouse (or former spouse) is the adjusted basis of the transferor spouse (§453B(g); §1041).

> **Note:** The nonrecognition rule does not apply if the spouse or former spouse receiving the obligation is a nonresident alien (§1041(d)).

Gifts

A gift of an installment obligation is a disposition. The gain or loss is the difference between the taxpayer's basis in the obligation and its fair market value at the time the gift is made (§453B(a); R.R. 79-371.

Cancellation

If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. The taxpayer's gain or loss is the difference between their basis in the obligation and its fair market value at the time of cancellation. If the taxpayer and the buyer are related, the fair market value of the obligation is considered to be no less than its full face value (§453B(f)).

Forgiving Part of the Debt

If the taxpayer accepts part payment on the balance of the buyer's installment debt and forgives the rest of the debt, the settlement is treated as a disposition of the installment obligation. The gain or loss is the difference between the taxpayer's basis in the obligation and the amount realized on the settlement (§453B(a)(1)).

If the taxpayer reduces the selling price but does not cancel the rest of the buyer's debt, it is not considered a disposition of the installment obligation. The taxpayer must refigure the gross profit percentage and apply it to payments received after the reduction (R.R. 55-429).

Assumptions

If the buyer of taxpayer's property sells it to someone else and the taxpayer agrees to let the new buyer assume the original buyer's installment obligation, the taxpayer has not disposed of the installment obligation. It is not a disposition even if the new buyer pays taxpayer a higher rate of interest than the original buyer (R.R. 82-122).

Death Transfers

The transfer of an installment obligation as a result of the death of the seller or other holder of the obligation is not a disposition. Unreported gains from the installment obligations are treated as items of gross income in respect of a decedent. This means that whoever receives the installment obligation as a result of the holder's death is taxed on the installment payments as the seller or other holder would have been if the holder lived to receive payments (§453B(c); §691(a)(4); §691(a)(5)).

However, if an installment obligation is canceled, becomes unenforceable, or transferred to the buyer, because of the death of the holder of the obligation, it is a disposition. The estate must figure its gain or loss on the disposition. If the holder and the buyer were related, the fair market value of the installment obligation is considered to be no less than its full face value (§453B(c); §691(a)(4); §691(a)(5)).

Basis

A taxpayer's basis in an installment obligation depends on the unpaid balance of the obligation and the gross profit percentage.

The amount of profit on installment sale payments the seller has not yet received from the buyer is determined by multiplying the unpaid balance by the gross profit percentage (§453B(b)).

The remainder of the unpaid balance is the taxpayer's basis in the obligation. It represents the part of the adjusted basis in the property sold that has not already been recovered in payment (from the buyer (§453B(b)).

Example

Several years ago, Dan sold some property on the installment method. The buyer still owes Dan $10,000 of the sales price. This is the unpaid balance of the buyer's installment obligation. Because Dan's gross profit percentage is 60%, $6,000 (60% of $10,000) is the profit owed Dan on the obligation. The rest of the unpaid balance, $4,000, is Dan's basis in the obligation.

Sale of Future Cash Flow

To avoid income at the time of the transaction, most taxpayers who receive cash for future cash flows prefer to characterize the transaction as a loan. However, several cases have involved taxpayers who have tried to accelerate income by "selling" the right to future cash flows (see *Mapco, Inc. v. United States*, 556 F.2d 1107 (Ct. Cl. 1977), *Hydrometals, Inc. v. Commissioner*, 31 TCM 1260 (1972) and *Martin v. Commissioner*, 56 TC 1255 (1971).

Review Questions

Under NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

7. Section 1060 provides rules for the allocation of the purchase price of a business into certain asset classes. Of the five asset classes under §1060, to which are highly liquid assets allocated?

a. Class I.

b. Class II.

c. Class III.

d. Class IV.

8. When a taxpayer sells real property to a customer as a part of his or her business, the sale can be a dealer disposition. Under §453, a dealer disposition of residential property is eligible for installment reporting in which of the following circumstances?

a. An individual buys a residential lot, and the dealer does not make improvements to the lot.

b. A residential lot is sold to a business.

c. The sale is of a timeshare interest permitting the purchaser to use the residential property for more than six weeks per year.

d. A timeshare interest is sold to a non-individual.

9. Under §453A(a)(1), when a taxpayer defers payments from certain dispositions during a year totaling more than $5 million, the tax-deferred income is subject to interest under the §453 installment method. Which of the following is subject to this provision?

a. installment obligations that arise from a disposition of property that is used in the business of farming.

b. installment obligations that come from a disposition of property that is produced in the trade of farming.

c. personal use property that is sold for a sales price that exceeds $150,000.

d. real property used in a taxpayer's trade and sold for a sales price that is over $150,000.

10. Several items are used in the computation of the amount of interest payable for installment obligations in excess of $5 million. Under §453A(c)(3), what item is figured by multiplying the gain with respect to an obligation by the maximum tax rate of the individual or corporation, whichever is applicable, for the tax year?

a. applicable percentage.

b. computation of interest.

c. deferred tax liability.

d. underpayment rate.

Answers & Explanations

1. The formula for recognized gain on §453 installment sales involves several items. What item is defined as everything received from a property sale?

a. Correct. The selling price is the total consideration received for the sale of the property.

b. Incorrect. The contract price is the total amount the seller will receive (exclusive of interest) when the transaction is finally completed. Often this is the same as the selling price minus the seller's debt that the buyer assumed.

c. Incorrect. The gross profit for an installment sale is the amount of gain reported on the installment method. To figure the gross profit, take the selling price minus the adjusted basis, commissions, and other expenses paid on the sale.

d. Incorrect. The recognized gain is equal to the total gain/contract price X payments received.

2. Completing the §453 installment sale worksheet requires an understanding of what is meant by "payments in the year of sale." Which of the following is excluded from such payments?

a. Incorrect. Payments in the year of sale *include* cash received as a down payment.

b. Correct. Payments in the year of sale *do not include* debt instruments given by the buyer to evidence the debt to the seller (§453(f)(3)). This is because the payments are not actually received in the sale year. However, if the instrument is payable on demand or readily tradable it will be treated as receipt of payment (§453(f)(4)).

c. Incorrect. Payments in the year of sale *include* FMV of other property received in the year of sale (unless that property is "like-kind" property). The parenthetical exception refers to the possibility of combining an installment sale with a like-kind exchange.

d. Incorrect. Payments in the year of sale *include* the portion of any of seller's debt that is assumed (or taken subject to) by the buyer and which exceeds the seller's basis for the property sold. This amount is often referred to as mortgage in excess of basis.

3. The original issue discount (OID) rules apply in cases where §483 fails to apply to a §453 installment sale. Under the OID rules of §§1271 through 1274, what is the imputed principal amount?

a. Incorrect. OID equals the stated principal amount on the note or contract *minus* the imputed principal amount.

b. Incorrect. The present value of the principal and interest payments is used to determine OID. It is the present value of the principal and interest payments that is determined by discounting the stream of payments at the AFR (or the lower of 9%, if applicable).

c. Incorrect. To compute OID, the imputed principal amount must be determined. To figure the imputed principal amount, the sum of the present values of the principal and interest payments (if any) due under the contract should be subtracted from the sum of the principal payments due under the contract.

d. Correct. The imputed principal amount constitutes the amount realized (see §1001) and will be the buyer's basis for the property.

4. Under §1038, when a seller repossesses real property to satisfy a purchase obligation, the seller can recognize gain. In this determination, what is excluded from the sales price or gain on the original sale?

a. Incorrect. When figuring gain on the original sale, the first computation that must be made is for consideration received. For this purpose, consideration includes the buyer's note or mortgage given to evidence the debt. Thus, the buyer's note or mortgage given to evidence the debt is included in the gain on the original sale.

b. Correct. The sales price or gain on the original sale does not include interest, whether stated or imputed. Interest is typically calculated separately and taxable as ordinary income. It is not considered money or property received on the sale.

c. Incorrect. Consideration, which is determined in figuring repossession on the installment sale method, includes liabilities of the seller assumed (or taken subject to) by the buyer. Thus, the seller's liabilities that the buyer assumes or takes subject to are included in the sales price or gain on the original sale.

d. Incorrect. The FMV of other property received from the buyer in the transaction is part of the consideration received, determined in the computation of gain on the original sale. Thus, the FMV of other property received from the buyer in the transaction is included in the sales price or gain on the original sale.

5. Under the §453 resale rule, when a seller (A) disposes of property under the installment method to a related person (B), and then B disposes of said property within two years and before he or she makes all payments, A must treat a portion or all of the amount realized by B as if A received it from the initial disposition. Under which of the following circumstances would this resale rule apply?

a. Incorrect. An exception to the resale rule is for a non-liquidating installment sale of stock to the issuing corporation. Thus, if the related party is the issuing corporation and the sale of stock is non-liquidating, the resale rule does not apply.

b. Incorrect. An exception to the resale rule is for a second disposition after the death of the installment seller or buyer. Thus, when B disposes of property subsequent to the death of A or B, the resale rule does not apply.

c. Correct. While an exception to the resale rule is for an involuntary conversion, when the initial sale occurred *before* the threat or eminence of conversion, there is no exception if the initial sale occurred *after* the threat. As a result, the related party resale restriction would apply.

d. Incorrect. An exception to the resale rule is for any transaction that does not have a tax avoidance purpose. Thus, if B disposes of the property and has no intention of avoiding taxes, the resale rule may not apply. However, this standard is difficult to apply on a practical level.

6. The Installment Sales Revision Act of 1980 fundamentally changed the installment method establishing most of its current structure. What is one of the long-standing results of this Act?

a. Incorrect. *Formerly*, installment reporting of gain from deferred payment sales was not available where all or a part of the selling price was subject to a contingency. The Act removed this restriction.

b. Correct. The Installment Sales Revision Act of 1980 drastically revised the installment sales rules as they apply to sales of reality and casual sales of personal property (i.e., nondealer sales). A major alteration of prior law is the application of §453 to any sale, the price of which is subject to a contingency.

c. Incorrect. *Formerly*, the seller had to recognize all of the gain in the year of sale where the price was subject to a contingency, even though some or all of the payments were to be made in future years. The Act removed this restriction.

d. Incorrect. *Prior law* required that the selling price had to be fixed and determinable in order to benefit from installment reporting. The Act removed this restriction.

7. Section 1060 provides rules for the allocation of the purchase price of a business into certain asset classes. Of the five asset classes under §1060, to which are highly liquid assets allocated?

a. Incorrect. Under §1060, cash and demand deposits belong in Class I.

b. Correct. Under §1060, highly liquid assets belong in Class II.

c. Incorrect. Under §1060, all assets other than Class I, II, IV, or V, both tangibles and non-§197 intangibles, belong in Class III.

d. Incorrect. Under §1060, §197 intangibles, except goodwill and going concern value, belong in Class IV.

8. When a taxpayer sells real property to a customer as a part of his or her business, the sale can be a dealer disposition. Under §453, a dealer disposition of residential property is eligible for installment reporting in which of the following circumstances?

a. Correct. Under §453(l)(2)(B)(ii)(II), gain on the sale of a residential lot by a dealer qualifies for installment reporting but only if the lot is sold to an individual and neither the dealer nor a related person is to make improvements to the lot. Nevertheless, the dealer must elect to pay interest on installment obligations from the sale.

b. Incorrect. Gain on the sale of a residential lot by a dealer does not qualify for installment reporting if the lot is sold to a business under this provision.

c. Incorrect. This section provides that gain on the installment sale of a timeshare by a dealer qualifies only if it is a timeshare right to use or timeshare ownership interest in residential real property for *not more than* six weeks per year. Thus, installment reporting is not available in this instance.

d. Incorrect. This section provides that gain on the installment sale of a timeshare by a dealer qualifies only if the timeshare is sold to an individual. Thus, installment reporting is not available in this case.

9. Under §453A(a)(1), when a taxpayer defers payments from certain dispositions during a year totaling more than $5 million, the tax-deferred income is subject to interest under the §453 installment method. Which of the following is subject to this provision?

a. Incorrect. This provision does not apply to installment obligations arising from the disposition of property that is *used in the business* of farming. Thus, no interest is imposed on such income.

b. Incorrect. This rule does not apply to installment obligations arising from the disposition of property that is *produced in the trade* of farming. Farming has a "blanket" exclusion.

c. Incorrect. This rule does not apply to installment obligations arising from the disposition of personal use property. Thus, no interest is imposed on this income under this provision.

d. Correct. Section 453A(a)(1) imposes interest on tax-deferred payments under the installment method to the extent the sum of deferred payments from certain dispositions during any year exceeds $5 million. This provision applies to the disposition of real property used in the taxpayer's trade or business or held for the production of rental income provided, in either case, the sales price exceeds $150,000.

10. Several items are used in the computation of the amount of interest payable for installment obligations in excess of $5 million. Under §453A(c)(3),

what item is figured by multiplying the gain with respect to an obligation by the maximum tax rate of the individual or corporation, whichever is applicable, for the tax year?

a. Incorrect. The applicable percentage is determined by dividing (1) the portion of the aggregate face amount of installment obligations outstanding as of the close of the taxable year in excess of $5 million by (2) the aggregate face amount of the installment obligations outstanding as of the close of the taxable year.

b. Incorrect. The amount of interest payable is determined under a three-component formula that requires: (1) the applicable percentage of (2) the deferred tax liability to be multiplied by (3) the underpayment rate.

c. Correct. Deferred tax liability is (1) the amount of gain with respect to an obligation that has not been recognized as of the close of the tax year multiplied by (2) the maximum individual or corporate tax rate (whichever is applicable) for the tax year.

d. Incorrect. The underpayment rate is the rate effective under §6621(a)(2) for the month with or within which the tax year ends.

Glossary

Accrual method: A method of accounting in which income and expense items are determined based upon the right to receive or the duty to pay.

Adjusted basis: The original basis of property increased by improvements and reduced by depreciation.

Applicable federal rate: A rate of interest used to determine imputed interest on below-market loans and original issue discount.

Carrying charge: The cost of storage space, insurance, and finance charges incurred when maintaining an asset.

Contract price: The total of all principal payments to be received on the installment sale.

Dealer: A person or taxpayer that regularly buys and sells property or inventory to customers in the ordinary course of their business.

Debt instrument: A written obligation or promise to repay a debt.

Gross profit percentage: A figure obtained by dividing the gross profit from an installment sale by the contract price.

Imputed interest: Imaginary interest income which is generated by §483. In many cases the effect of §483 is to convert part of the sales price into interest, creating a deduction for the buyer and interest income for the seller.

Income forecast method: A method of depreciation where the basis of depreciable property is written off in proportion to total anticipated future gross income.

Installment sale: A sale of property where at least one payment will be received in a taxable year following the year of sale.

Like-kind exchange: a reciprocal transfer of property without the substantial interjection of cash.

Original issue discount: The shortfall between the issue price of a debt instrument and its stated redemption price at maturity.

Suspended losses: Losses from passive activities which cannot be used in the current year.

Tax year: An annual accounting period for reporting income and keeping records.

Unrealized receivables: The right to payment for goods delivered or services rendered.

Wrap-around mortgage: A junior mortgage with a face value of both the amount it secures and the balance due under a senior mortgage.

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Installment Sales

Mini-Course Description & Study Guide

An installment sale is a sale of property where one or more payments are received after the close of the tax year. This mini-course discusses the particulars of installment sales, including requirements, calculations, and pitfalls. Cross issues such as a combined installment sale and like-kind exchange, the impact of related parties, pledging, repossession and contingent payments are reviewed. Also, the importance of recognizing the dangers of dealer status, inventory, purchase price allocation, and installment note disposition are emphasized.

Completion Deadline & Exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Course Level: Overview. This program is appropriate for professionals at all organizational levels.

Field of Study: Taxes

Prerequisite: General understanding of federal income taxation.

Advanced Preparation: None

Recommended CPE Hours: CPAs — 2 Tax
EAs and CRTPs — 2 Federal Tax

Course qualifications: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, LLC (Registry ID: 104931)

Expiration Date: July 2024*

*Exam must be completed within one year of the date of purchase

Learning Assignment & Objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

ASSIGNMENT

At the start of the materials, participants should identify the following topics for study:

* Installment method
* Installment income
* Imputed interest & OID
* Related party sales
* Like-kind exchanges
* Contingent payments or price
* Sale of a business
* Dealer dispositions
* Installment notes in excess of $5 million
* Dispositions of installment obligations

Learning Objectives

After reading the materials, participants will be able to:

1. Recognize the importance, particularly in tax deferral, of the installment method and, identify §453 requirements and installment method terminology.

2. Specify the imputed interest, OID, and §1038 repossession rules affecting installment sales and subsequent repossessions.

3. Identify the following §453 pitfalls and complexities: the related party limitation, the regulations governing the use of the installment sale method in like-kind exchanges, and the contingent payment sale rules.

4. Determine how to allocate and report installments payments among identified asset classes using R.R. 76-110 and the residual method recognizing §453 prohibitions on certain assets regarding dealer dispositions and inventory.

5. Identify the amount of interest payable on tax-deferred income when §453 dispositions exceed $5 million and circumstances considered taxable dispositions of installment obligations to determine when any gain or loss is recognized.

After studying the materials, answer the exam questions 1 to 10.

Notice

This course and test have been adapted from materials and information contained in the above text and any supplemental material provided. This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

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Program title: **Installment Sales (2023)**

If applicable, program instructor: _____

Program date: _____ Participant name (optional): _____

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? _____
2. If applicable, were prerequisite requirements appropriate and sufficient? _____
3. Were the program materials accurate? _____
4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? _____
5. Was the time allotted to the learning activity appropriate? _____
6. If applicable, were the individual instructors knowledgeable and effective? _____
7. Were the facilities and/or technological equipment appropriate? _____
8. Were the handout and/or advanced preparation materials satisfactory? _____
9. Were the audio and visual materials effective? _____

IRS Course Number (if applicable): CRA7E-T-00639-23-S

TTP (CTEC) Course Number (if applicable): 1019-CE-1239

Date course completed: _____

Number of hours it took to complete the course: _____

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Examination for Spidell's Installment Sales

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (7 of 10) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. Jake is negotiating a sale of some of his company's manufacturing equipment to a buyer. The sale involves monthly payments over several years and Jake has decided to use the §453 installment method. His reason for using this method should be to:

   a) Avoid reporting all gain in the year of sale but, as the payments are received
   b) Be able to use the cash method of accounting rather than the accrual method
   c) Ensure that the gain from the sale is the excess of the amount realized over the property's adjusted basis
   d) Guarantee final payment from the buyer

2. Fred has negotiated an installment sale and is filling out Form 6252, *Installment Sale Income*. He is learning that Form 6252 involves statutory terminology and seeks your help. For example, what is the sum of the adjusted basis, selling expenses, and depreciation recapture income?

   a) Allocation amount
   b) Contract amount
   c) Installment sale basis
   d) Original basis

3. Dan has negotiated a principal only installment sale of a small farm and now finds he is subject to §483 imputed interest rules and must use a discount rate to calculate the present value of the installment payments. In making this calculation, Dan should know that the imputed interest rates are linked to the:

   a) Rates paid on the federal government's debt
   b) Rates paid by private banks to depositors
   c) Rates paid by investors on margin accounts
   d) Rates paid by corporations on bonds and warrants

4. Kevin likes to buy and hold real estate but occasionally sells a parcel on the installment method to pay basic living expenses. As his tax advisor, you should warn Kevin that, if he uses the installment method, he would be unable to recognize a loss or take a bad debt deduction when:

   a) Property is stolen
   b) Real property is sold for 100% cash
   c) Repossessing real property to fulfill a purchase obligation
   d) Real property is destroyed by fire

5. In order to create a safe harbor and avoid a taxable sale through the actual or constructive receipt of funds, William transfers property to an intermediary who promises to sell the original property, acquire replacement property, and transfer it to William. To ensure this arrangement, William would want to negotiate what is commonly referred to as a(n):

   a) Dealer disposition
   b) Delayed exchange
   c) Replacement sale
   d) Involuntary conversion

6. Sven has agreed to a contingent payment sale since the selling price of the property he is disposing of cannot be determined during the tax year. However, by the close of the tax year, he is able to figure out the most the proceeds from the sale could be. In this case, Sven would treat the sale as:

   a) Having no fixed term
   b) Having a maximum selling price
   c) Qualifying for the alternative sales method
   d) Being a delayed installment sale

7. Deidre has negotiated a sale in which she installment sold several unrelated assets of the same type under one contract. As a result, she would report the sale under §453 as a:

   a) Class transaction using the residual method
   b) Single transaction for the installment method
   c) As several transactions for the income forecast method
   d) Separate sale of each asset under §453

8. At a tax seminar for real estate developers, the installment sale of subdivided property is a topic of interest. As a result of the Revenue Act of 1987, you should point out that all installment payments are deemed received in the year of sale for:

   a) Dispositions of co-op stock
   b) Dispositions of improved real property
   c) Dispositions of partnership interests
   d) Dispositions by dealers

9. Sally negotiated an installment sale in which she sold an apartment building for $350,000 with the installment obligation later pledged as security for a loan. Under Section 453A(d)(1), the loan's net proceeds would be considered:

   a) A tax-deferred payment
   b) A receipt of an obligation payment
   c) Nontaxable loan proceeds
   d) A fully taxable disposition

10. You are participating in a tax panel for a group of real estate professionals and are explaining that, under §453B, the transfer of an installment obligation can trigger gain or loss. In your explanation, an example of such a disposition would be:

    a) An interest rate hike on an installment obligation with a new obligor
    b) The transfer of any installment obligation as collateral for a loan
    c) The substitution of 2 promissory notes for the original note and deed of trust
    d) Incidents of ownership being surrendered with a transfer of the obligation to a bank

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Answer Sheet for Spidell's Installment Sales

Name: _____ Signature: _____

Company: _____

Address: _____

City/State/ZIP: _____

Phone: _____ Fax: _____

E-mail: _____

License/Registration No.: _____ ☐ CPA ☐ EA ☐ CRTP (CTEC) ☐ Atty

PTIN: _____

If you are an EA or CRTP (CTEC), we must have your PTIN in order to report your hours to the IRS.

Deadline to Complete the Course: *In accordance with NASBA and IRS requirements, you have one year from the date of purchase to complete the examination and submit it to our office for grading.*

This examination is designed to test your knowledge on the content of **Spidell's Installment Sales**. We will grade the answer sheet, and if you answer 70% or more of the questions correctly you will be sent a certificate of completion. Passing CPAs will be recommended for two hours of continuing education credit, and passing EAs and CRTPs will be recommended for two federal tax hours of continuing education.

* Attorneys will be recommended for 1.5 hours of General MCLE/Tax Specialization credit.

To complete your exam: Go to https://cpe.spidell.com/ and login with your e-mail address and license number to complete your exam. Click on "view courses to be completed" then "start exam". When you are finished click "submit".

Or, fax your answer sheet to (714) 776-9906.

Final Exam Questions

1. ☐ **a)** Avoid reporting all gain in the year of sale but, as the payments are received
   ☐ **b)** Be able to use the cash method of accounting rather than the accrual method
   ☐ **c)** Ensure that the gain from the sale is the excess of the amount realized over the property's adjusted basis
   ☐ **d)** Guarantee final payment from the buyer

2. ☐ **a)** Allocation amount
   ☐ **b)** Contract amount
   ☐ **c)** Installment sale basis
   ☐ **d)** Original basis

3. ☐ **a)** Rates paid on the federal government's debt
   ☐ **b)** Rates paid by private banks to depositors
   ☐ **c)** Rates paid by investors on margin accounts
   ☐ **d)** Rates paid by corporations on bonds and warrants

4. ☐ **a)** Property is stolen
   ☐ **b)** Real property is sold for 100% cash
   ☐ **c)** Repossessing real property to fulfill a purchase obligation
   ☐ **d)** Real property is destroyed by fire

5. ☐ **a)** Dealer disposition
   ☐ **b)** Delayed exchange
   ☐ **c)** Replacement sale
   ☐ **d)** Involuntary conversion

6. ☐ **a)** Having no fixed term
   ☐ **b)** Having a maximum selling price
   ☐ **c)** Qualifying for the alternative sales method
   ☐ **d)** Being a delayed installment sale

7. ☐ **a)** Class transaction using the residual method
   ☐ **b)** Single transaction for the installment method
   ☐ **c)** As several transactions for the income forecast method
   ☐ **d)** Separate sale of each asset under §453

8. ☐ **a)** Dispositions of co-op stock
   ☐ **b)** Dispositions of improved real property
   ☐ **c)** Dispositions of partnership interests
   ☐ **d)** Dispositions by dealers

9. ☐ **a)** A tax-deferred payment
   ☐ **b)** A receipt of an obligation payment
   ☐ **c)** Nontaxable loan proceeds
   ☐ **d)** A fully taxable disposition

10. ☐ **a)** An interest rate hike on an installment obligation with a new obligor
    ☐ **b)** The transfer of any installment obligation as collateral for a loan
    ☐ **c)** The substitution of 2 promissory notes for the original note and deed of trust
    ☐ **d)** Incidents of ownership being surrendered with a transfer of the obligation to a bank