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Installment Sales

For use in preparing
2001 Returns



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Important Change

Accrual basis taxpayers. For sales occurring after December 16, 1999, accrual basis taxpayers were required to report installment sales under the accrual method of accounting. The Installment Tax Correction Act of December 28, 2000, repealed that requirement.

If you entered into an installment sale after December 16, 1999, and filed an income tax return by April 16, 2001, reporting the sale on an accrual method, you have IRS approval to revoke your effective election out of the installment method. (See *Electing Out of the Installment Method*).

To revoke the election, you must file an amended return for the year of the installment sale (and any other year affected by the sale), reporting the gain on the installment method. (See *Figuring Installment Income* and *Reporting Installment Income*). You generally have three years from the due date of the original return to file an amended return.

Important Reminder

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Introduction

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. In an installment sale you report part of your gain when you receive each payment. You cannot use the installment method to report a loss.

This publication discusses the general rules that apply to all installment sales. It also discusses more complex rules that apply only when certain conditions exist or certain types of property are sold.

If you sell your home or other nonbusiness property under an installment plan, you will need to read only the *General Rules*. If you sell business or rental property or have a like-kind exchange or other complex situation, see the appropriate discussion under *Other Rules*, later.

If you sell your entire interest in a passive activity, special rules apply to the treatment of passive activity losses. See Publication 925 for information on this topic.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 538** Accounting Periods and Methods
- 541** Partnerships
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses
- 551** Basis of Assets
- 925** Passive Activity and At-Risk Rules

Form (and Instructions)

- 4797** Sales of Business Property
- 6252** Installment Sale Income

See *How To Get Tax Help* near the end of this publication for information about getting publications and forms.

What Is an Installment Sale?

An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. The installment sale rules do not apply to the regular sale of inventory. See *Sale of a Business* under *Other Rules*, later.

TIP *If you finance the purchase of your property, instead of having the buyer get a loan or mortgage from a third party, you probably have an installment sale. It is not an installment sale if the buyer borrows the money from a third party and then pays you the total selling price.*

General Rules

If a sale qualifies as an installment sale, the gain must be reported under the installment method unless you elect out of using the installment method.

See *Electing Out of the Installment Method* under *Other Rules*, later, for information on recognizing the entire gain in the year of sale.

Installment obligation. The buyer's obligation to make future payments to you can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you.

Stock or securities. You cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain on the sale in the year in which the trade date falls.

Dealer sales. Sales of personal property by a person who regularly sells or otherwise disposes of the same type of property on the installment plan cannot be reported under the installment method. This rule also applies to real property held for sale to customers in the ordinary course of a trade or business. However, the rule does not apply to an installment sale of property used or produced in farming.

Special rule. Dealers of time-shares and residential lots can report certain sales on the installment method if they elect to pay a special interest charge. For more information, see section 453(l) of the Internal Revenue Code.

Sale at a loss. If your sale results in a loss, you cannot use the installment method. If the loss is on an installment sale of business assets, you can deduct it only in the tax year of sale. You cannot deduct a loss on the sale of property owned for personal use.

Unstated interest. If your sale calls for payments in a later year and the sales contract provides for little or no interest, you may have to figure unstated interest, even if you have a loss. See *Unstated Interest and Original Issue Discount*, later.

Figuring Installment Income

Each payment on an installment sale usually consists of the following three parts.

- 1) Interest income.
- 2) Return of your adjusted basis in the property.
- 3) Gain on the sale.

In each year you receive a payment, you must include the interest part in income, as well as the part that is your gain on the sale. You do not include in income the part that is the return of your basis in the property. Basis is the amount of your investment in the property for tax purposes.

Interest income. You must report interest as ordinary income. Interest is generally not included in a down payment. However, you may have to treat part of each later payment as interest, even if it is not called interest in your agreement with the buyer. See *Unstated Interest and Original Issue Discount*, later.

Return of basis and gain on sale. The rest of each payment is treated as if it were made up of two parts. One part is a tax-free return of your adjusted basis in the property. The other part is your gain.

Figuring gain part of payment. To figure what part of any payment is gain, multiply the payment (less interest) by the gross profit percentage. Use the following worksheet to figure the gross profit percentage.

1) Selling price	_____
2) Installment sale basis:	
Adjusted basis of property	_____
Selling expenses	_____
Depreciation recapture	_____
3) Gross profit (line 1 - line 2)	_____
4) Contract price	_____
5) Gross profit percentage	
(line 3 ÷ line 4)	=====

Selling price. The selling price is the total cost of the property to the buyer. It includes any money and the fair market value of any property you are to receive. Fair market value (FMV) is discussed later. It also includes any debt the buyer pays, assumes, or takes, to which the property is subject. The debt could be a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes you owe on the property. If the buyer pays any of your selling expenses, that amount is also included in the selling price. The selling price does not include interest, whether stated or unstated.

Installment sale basis. Three items comprise installment sale basis.

- Adjusted basis
- Selling expenses
- Depreciation recapture

Adjusted basis. Basis is the amount of your investment in the property for tax purposes. The way you figure basis depends on how you acquire the property. The basis of property you buy is generally its cost. The basis of property you inherit, receive as a gift, build yourself, or receive in a tax-free exchange is figured differently.

While you own personal-use property, various events may change your original basis.

Some events, such as adding rooms or making permanent improvements, increase basis. Others, such as deductible casualty losses or depreciation previously allowed or allowable, decrease basis. The result is adjusted basis.

For more information on how to figure basis and adjusted basis, see Publication 551.

Selling expenses. Selling expenses are any expenses 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.

Depreciation recapture. If you took depreciation deductions on the asset, you may need to recapture part of the gain on the sale as ordinary income. See *Depreciation Recapture Income*, later.

Gross profit. Gross profit is the total gain you report on the installment method.

To figure your gross profit, subtract your installment sale basis from the selling price. If the property you sold was your home, subtract from the gross profit any gain you can exclude. See *Sale of your home*, later, under *Reporting Installment Income*.

Contract price. The contract price is the total of all principal payments you are to receive on the installment sale. It also includes payments you are considered to receive. See *Payments Received*, later.

If part of the selling price is paid in cash and you hold a mortgage payable from the buyer to you for the remainder, then the contract price includes both.

Gross profit percentage. A certain percentage of each payment (after subtracting interest) is reported as gain from the sale. It is called the "gross profit percentage" and is figured by dividing your gross profit from the sale by the contract price.

The gross profit percentage generally remains the same for each payment you receive. However, see the example under *Selling price reduced*, later, for a situation where the gross profit percentage changes.

Example. You sell property at a contract price of \$2,000 and your gross profit is \$500. Your gross profit percentage is 25% (\$500 ÷ \$2,000). After subtracting interest, you report 25% of each payment, including the down payment, as gain from the sale for the tax year you receive the payment.

Amount to include in income. Each year as you receive payments on the installment sale, multiply the payments (less interest) by the gross profit percentage to determine the amount you must include in income for the tax year. In certain circumstances, you may be considered to have received a payment, even though you received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be considered a payment. For a detailed discussion, see *Payments Received*, later.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. You must then refigure the gross profit percentage for the remaining payments. Refigure your gross profit using the reduced sale price and then subtract the gain

already reported. Spread the remaining gain over the future installments.

Example. In 1999, you sold land with a basis of \$40,000 for \$100,000. Your gross profit was \$60,000. You received a \$20,000 down payment and the buyer's note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 12% interest, beginning in 2000. Your gross profit percentage is 60%. You reported a gain of \$12,000 on each payment received in 1999 and 2000.

In 2001, you and the buyer agreed to reduce the purchase price to \$85,000 and payments during 2001, 2002, and 2003 are reduced to \$15,000 for each year.

The new gross profit percentage, 46.67%, is figured as follows.

1) Reduced selling price	\$85,000
2) Minus: Basis	<u>40,000</u>
3) Adjusted gross profit	\$45,000
4) Minus: Gain reported in 1999 & 2000	<u>24,000</u>
5) Gain to be reported	<u>\$21,000</u>
6) Selling price to be received:	
Reduced selling price	\$85,000
Minus: Payments received in 1999 and 2000	<u>40,000</u>
	\$45,000
7) New gross profit percentage (line 5 ÷ line 6)	<u>46.67%</u>

You will report a gain of \$7,000 (46.67% of \$15,000) on each of the \$15,000 installments due in 2001, 2002, and 2003.

Reporting Installment Income

Form 6252. Use Form 6252 to report an installment sale in the year it takes place and to report payments received in later years. Attach it to your tax return for each year.

Form 6252 will help you determine the gross profit, contract price, gross profit percentage, and how much of each payment to include in income.

Form 6252 is divided into the following parts.

- 1) Part I, *Gross Profit and Contract Price*, is completed for the year of sale only.
- 2) Part II, *Installment Sale Income*, is completed for the year of sale and for any year you receive a payment or are considered to have received a payment.
- 3) Part III, *Related Party Installment Sale Income*, is completed if you sold the property to a related person, as discussed later under *Sale to a Related Person*.

Year of sale. Answer the questions at the beginning of the form and complete Part I and Part II. Line 3 asks whether you sold the property to a related party. If you answer "Yes," answer the question on line 4 and complete Part III.

Later years. Answer the questions at the beginning of the form and complete Part II for each year in which you receive a payment on the sale. If you sold the property to a related person, you may have to complete Part III also.

Schedule D (Form 1040). Enter the gain figured on Form 6252 (line 26) for personal-use property (capital assets) on Schedule D (Form 1040), *Capital Gains and Losses*. If your gain from the installment sale qualifies for long-term capital gain treatment in the year of sale, it will

continue to qualify in later tax years. Your gain is long-term if you owned the property for more than one year when you sold it.

Form 4797. An installment sale of property used in your business or that earns rent or royalty income may result in a capital gain, an ordinary gain, or both. All or part of any gain from its disposition may be ordinary gain from depreciation recapture. Use Form 4797 to report these transactions and to determine the ordinary or capital gain or loss.

Sale of your home. If you sell your home, you may be able to exclude all or part of the gain on the sale. See Publication 523 for information about excluding the gain. If the sale is an installment sale, any gain you exclude is not included in gross profit when figuring your gross profit percentage.

Seller-financed mortgage. Special reporting procedures apply if you finance the sale of your home to an individual.

When you report interest income received from a buyer who uses the property as a personal residence, write the buyer's name, address, and social security number (SSN) on line 1 of Schedule B (Form 1040) or Schedule 1 (Form 1040A).

When deducting the mortgage interest, the buyer must write your name, address, and SSN on line 11 of Schedule A (Form 1040).

If either person fails to include the other person's SSN, a \$50 penalty will be assessed.

Other Rules

The rules discussed in this part of the publication apply only in certain circumstances or to certain types of property. The rules cover the following topics.

- Electing out of the installment method.
- Payments received, including those considered received.
- An escrow account.
- Depreciation recapture income.
- A sale to a related person.
- A like-kind exchange.
- A contingent payment sale.
- A single sale of several assets.
- The sale of a business.
- Unstated interest and original interest discount.
- Disposition of an installment obligation.
- A repossession.

Electing Out of the Installment Method

If you elect not to use the installment method, you generally report the entire gain in the year of sale, even though you do not receive all the sale proceeds in that year.

To figure the gain to report, use the fair market value (FMV) of the buyer's installment obligation which represents the buyer's debt to you. Notes, mortgages, and land contracts are

examples of obligations that are included at FMV.

You must figure the FMV of the buyer's installment obligation, whether or not you would actually be able to sell it. If you use the cash method of accounting, the FMV of the obligation will never be considered to be less than the FMV of the property sold (minus any other consideration received).

Example. You sold a parcel of land for \$50,000. You received a \$10,000 down payment and will receive the balance over the next 10 years at \$4,000 a year, plus 8% interest. The buyer gave you a note for \$40,000. The note had an FMV of \$40,000. You paid a commission of 6%, or \$3,000, to a broker for negotiating the sale. The land cost \$25,000 and you owned it for more than one year. You decide to elect out of the installment method and report the entire gain in the year of sale.

Gain realized:

Selling price	.....	\$50,000	
Minus: Property's adj. basis	.....	\$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: Property's adj. basis	.....	\$25,000	
Commission	.....	3,000	28,000
Gain recognized	.....		\$22,000

The recognized gain of \$22,000 is long-term capital gain. Since you include the entire gain in income in the year of sale, you do not include in income any principal payments you receive in later tax years. The interest on the note is ordinary income and is reported as interest income each year.

How to elect out. To make this election, do not report your sale on Form 6252. Instead, report it on Schedule D (Form 1040) or Form 4797, whichever applies.

When to elect out. Make this election by the due date, including extensions, for filing your tax return for the year the sale takes place.

Automatic six-month extension. If you timely file your tax return without making the election, you can still make the election by filing an amended return within 6 months of the due date of your return (excluding extensions). Write "Filed pursuant to section 301.9100-2" at the top of the amended return and file it where the original return was filed.

Revoking the election. Once made, the election can only be revoked with IRS approval. A revocation is retroactive. You will not be allowed to revoke the election in either of the following situations.

- One of the purposes is to avoid federal income tax.
- The tax year in which any payment was received has closed.

Payments Received

Including Payments Considered Received

You must figure your gain each year on the payments you receive, or are treated as receiving,

from an installment sale. These payments include the down payment and each later payment of principal on the buyer's debt to you.

In certain situations, you are considered to have received a payment, even though the buyer does not pay you directly. These situations occur when the buyer assumes or pays any of your debts, such as a loan, or pays any of your expenses, such as a sales commission. See *Mortgage less than basis* for an exception to this rule.

Buyer pays seller's expenses. If the buyer pays any of your expenses related to the sale of your property, it is considered a payment to you in the year of sale. Include these expenses in the selling and contract prices when figuring the gross profit percentage.

Buyer assumes mortgage. If the buyer assumes or pays off your mortgage, or otherwise takes the property subject to the mortgage, the following rules apply.

Mortgage less than basis. If the buyer assumes a mortgage that is less than your installment sale basis in the property, it is not considered a payment to you. It is actually a recovery of your basis. The selling price minus the mortgage equals the contract price.

Example. You sell property with an adjusted basis of \$19,000. You have selling expenses of \$1,000. The buyer assumes your existing mortgage of \$15,000 and agrees to pay you \$10,000 (a cash down payment of \$2,000 and \$2,000 (plus 12% interest) in each of the next 4 years).

The selling price is \$25,000 (\$15,000 + \$10,000). Your gross profit is \$5,000 (\$25,000 - \$20,000 installment sale basis). The contract price is \$10,000 (\$25,000 - \$15,000 mortgage). Your gross profit percentage is 50% (\$5,000 ÷ \$10,000). You report half of each \$2,000 payment received as gain from the sale. You also report all interest you receive as ordinary income.

Mortgage more than basis. If the buyer assumes a mortgage that is more than your installment sale basis in the property, you recover your entire basis. You are also relieved of the obligation to repay the amount borrowed. The part of the mortgage greater than your basis is treated as a payment received in the year of sale.

To figure the contract price, subtract the mortgage from the selling price. This is the total amount you will directly receive from the buyer. Add to this amount the payment you are considered to receive (the difference between the mortgage and your installment sale basis). The contract price is then the same as your gross profit from the sale.

If the mortgage the buyer assumes is equal to or more than your installment sale basis, the gross profit percentage will always be 100%.

Example. The selling price for your property is \$9,000. The buyer will pay you \$1,000 annually (plus 8% interest) over the next 3 years and assume an existing mortgage of \$6,000. Your adjusted basis in the property is \$4,400. You have selling expenses of \$600, for a total installment sale basis of \$5,000. The part of the mortgage that is more than your 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:

Selling price	.....	\$9,000	
Minus: Mortgage	.....	(6,000)	
Amount actually received	.....		<u>\$3,000</u>
Add difference:			
Mortgage	.....	\$6,000	
Less: Installment sale basis	.....	5,000	1,000
Contract price	.....		\$4,000

Your gross profit on the sale is also \$4,000:

Selling price	.....	\$9,000	
Minus: Installment sale basis	.....	(5,000)	
Gross profit	.....		\$4,000

Your gross profit percentage is 100%. Report 100% of each payment as gain from the sale. Treat the \$1,000 difference between the mortgage and your installment sale basis as a payment and report 100% of it as gain in the year of sale.

Mortgage canceled. If the buyer of your property is the person who holds the mortgage on it, your debt is canceled, not assumed. You are considered to receive a payment equal to the outstanding canceled debt.

Example. Mary Jones loaned you \$4,500 in 1996 in exchange for a note mortgaging a tract of land you owned. On April 4, 2001, she bought the land for \$7,000. At that time, \$3,000 of her loan to you was outstanding. She agreed to forgive this \$3,000 debt and to pay you \$2,000 (plus interest) on August 1, 2001, and \$2,000 on August 1, 2002. She did not assume an existing mortgage. She canceled the \$3,000 debt you owed her. You are considered to have received a \$3,000 payment at the time of the sale.

Buyer assumes other debts. If the buyer assumes any other debts, such as a loan or back taxes, it may be considered a payment to you in the year of sale.

If the buyer assumes the debt instead of paying it off, only part of it may have to be treated as a payment. Compare the debt to your installment sale basis in the property being sold. If the debt is less than your 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 your installment sale basis is considered a payment. These rules are the same as the rules discussed earlier under *Buyer assumes mortgage*. However, they apply only to the following types of debt the buyer assumes.

- 1) Those acquired from ownership of the property you are selling, such as a mortgage, lien, overdue interest, or back taxes.
- 2) Those acquired in the ordinary course of your business, such as a balance due for inventory you purchased.

If the buyer assumes any other type of debt, such as a personal loan, it is treated as if the buyer had paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to you in the year of sale.

Payment of property. If you receive property rather than money from the buyer, it is still considered a payment. However, see *Like-Kind Exchange*, later. The amount of the payment is the property's FMV on the date you receive it.

Fair market value (FMV). This is the price at which property would change hands between

a willing buyer and a willing seller who both have a reasonable knowledge of all the necessary facts. If your installment sale fits this description, the value assigned to property in your agreement with the buyer is good evidence of its FMV.

Third-party note. If the property the buyer gives you is a third-party note (or other obligation of a third party), you are considered to have received a payment equal to the note's FMV. Because the note is itself a payment on your installment sale, any payments you later receive from the third party are not considered payments on the sale.

Example. You sold real estate in an installment sale. As part of the down payment, the buyer assigned to you a \$5,000, 8% interest third-party note. The FMV of the third-party note at the time of the sale was \$3,000. This amount, not \$5,000, is a payment to you in the year of sale. Because the third-party note had an FMV equal to 60% of its face value (\$3,000 ÷ \$5,000), 60% of each principal payment you receive on this note is a nontaxable return of capital. The remaining 40% is ordinary income.

Bond. A bond or other evidence of debt you receive from the buyer that is payable on demand is treated as a payment in the year you receive it. If you receive a government or corporate bond that has interest coupons attached or that can be readily traded in an established securities market, you are considered to have received payment equal to the bond's FMV.

Buyer's note. The buyer's note (unless payable on demand) is not considered payment on the sale. However, its full face value is included when figuring the selling price and the contract price. Payments you receive on the note are used to figure your gain in the year received.

Guarantee. If a third party or government agency guarantees the buyer's payments to you on an installment obligation, the guarantee itself is not considered payment.

Installment obligation used as security (pledge rule). If you use 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 and it applies if the selling price of the property is over \$150,000. It does not apply to the following dispositions.

- 1) Sales of property used or produced in farming.
- 2) Sales of personal-use property.
- 3) Qualifying sales of time-shares and residential lots.

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

- 1) The date the debt becomes secured.
- 2) The date you receive the debt proceeds.

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. For sales after December 16, 1999, if you have the **right** to transfer an installment obliga-

tion in payment of a loan, the loan is considered directly secured.

Limit. The net debt proceeds treated as a payment on the pledged installment obligation cannot be more than the excess of item (1) over item (2), below.

- 1) The total contract price on the installment sale.
- 2) Any payments received on the installment obligation before the date the net debt proceeds are treated as a payment.

Installment payments. The pledge rule accelerates the reporting of the installment obligation payments. Do not report payments received on the obligation after it has been pledged until the payments received exceed the amount reported under the pledge rule.

Exception. The pledge rule does not apply to debt incurred after December 17, 1987, to refinance a debt under the following circumstances.

- 1) The debt was outstanding on December 17, 1987.
- 2) The debt was secured by that installment sale obligation on that date and at all times thereafter until the refinancing occurred.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt so long as a person other than the creditor or a person related to the creditor provides the refinancing.

This exception applies only to the refinancing that does not exceed the principal of the original debt immediately before the refinancing. Any excess is treated as a payment on the installment obligation.

Escrow Account

In some cases, the sales agreement or a later agreement may call for the buyer to establish an irrevocable escrow account from which the remaining installment payments (including interest) are to be made. These sales cannot 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, you no longer rely on the buyer for the rest of the payments, but on the escrow arrangement.

Example. You sell property for \$10,000. The sales agreement calls for a down payment 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. You cannot report the sale on the installment method because the full purchase price is considered received in the year of sale. You report the entire gain in the year of sale.

Escrow established in a later year. If you make 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.

Substantial restriction. If an escrow arrangement imposes a substantial restriction on your

right to receive the sale proceeds, the sale can 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.

Depreciation Recapture Income

If you sell property for which you claimed a depreciation deduction, you must report any depreciation recapture income in the year of sale, whether or not an installment payment was received that year. Figure your depreciation recapture income (including the section 179 deduction and the section 179A deduction recapture) in Part III of Form 4797. Report the recapture income in Part II of Form 4797 as ordinary income in the year of sale. The recapture income is also included in Part I of Form 6252. However, the gain equal to the recapture income is reported in full in the year of the sale. Only the gain greater than the recapture income is reported on the installment method. For more information on depreciation recapture, see chapter 3 in Publication 544.

The recapture income reported in the year of sale is included in your installment sale basis in determining your gross profit on the installment sale. Determining gross profit is discussed under *General Rules*, earlier.

Sale to a Related Person

Two special rules apply to an installment sale between related persons. Test your sale against Rule 1 first. If Rule 1 does not apply, test your sale against Rule 2. For purposes of these rules, spouses, children, grandchildren, brothers, sisters, and parents are all considered related persons. A partnership or corporation in which you have an interest, or an estate or trust with which you have a connection, can also be considered a related person.

For more information on these kinds of sales, see section 453 of the Internal Revenue Code.

Rule 1—Sale of Depreciable Property

If you sell depreciable property to certain related persons, you cannot report the sale using the installment method. See Rule 2 when selling nondepreciable property. Instead, all payments to be received are considered received in the year of sale. Depreciable property for this rule is any property the purchaser can depreciate.

Payments to be received include the total of all noncontingent payments and the FMV of any payments contingent as to amount.

In the case of contingent payments for which the FMV cannot be reasonably determined, your basis in the property is recovered proportionately. The purchaser cannot increase the basis of the property acquired in the sale before the seller includes a like amount in income.

Exceptions to Rule 1. Rule 1 will not apply if no significant tax deferral benefit will be derived from the sale. You must show to the satisfaction of the IRS that avoidance of federal income tax

was not one of the principal purposes of the sale.

Rule 2—Sale and Resale

Generally, a special rule applies if you sell or exchange property to a related person in the installment method (first disposition) who then sells, exchanges, or gives away the property (second disposition) under the following circumstances.

- The related person makes the second disposition before making all payments on the first disposition.
- The related person disposes of the property within 2 years of the first disposition.

Under this rule, you treat part or all of the amount the related person realizes (or the FMV if the disposed property is not sold or exchanged) from the second disposition as if you received it at the time of the second disposition.

Example 1. In 2000, Harvey Green sold farm land 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. His installment sale basis for the farm land was \$250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50% (gross profit of \$250,000 ÷ contract price of \$500,000). He received \$100,000 in 2000 and included \$50,000 in income for that year (\$100,000 × 0.50). Bob made no improvements to the property and sold it to Alfalfa Inc., in 2001 for \$600,000 after making the payment for that year. The amount realized from the second disposition is \$600,000. Harvey figures his installment sale income for 2001 as follows:

Lesser of: 1) Amount realized on second disposition, or 2) Contract price on first disposition	\$500,000
Subtract: Sum of payments from Bob in 2000 and 2001	– 200,000
Amount treated as received because of second disposition	\$300,000
Add: Payment from Bob in 2001	+ 100,000
Total payments received and treated as received for 2001	\$400,000
Multiply by gross profit %	× .50
Installment sale income for 2001	\$200,000

Harvey will not include in his installment sale income any principal payments he receives on the installment obligation for 2002, 2003, and 2004 because he has already reported the total payments of \$500,000 from the first disposition (\$100,000 in 2000 and \$400,000 in 2001).

Example 2. Assume the facts are the same as *Example 1* except that Bob sells the property for only \$400,000. The gain for 2001 is figured as follows:

Lesser of: 1) Amount realized on second disposition, or 2) Contract price on first disposition	\$400,000
Subtract: Sum of payments from Bob in 2000 and 2001	– 200,000
Amount treated as received because of second disposition	\$200,000
Add: Payment from Bob in 2001	+ 100,000
Total payments received and treated as received for 2001	\$300,000
Multiply by gross profit %	× .50
Installment sale income for 2001	\$150,000

Harvey receives a \$100,000 payment in 2002 and another in 2003. They are not taxed because he treated the \$200,000 from the disposition in 2001 as a payment received and paid tax on the gain. In 2004, he receives the final \$100,000 payment. He figures the gain he must recognize in 2004 as follows:

Total payments from the first disposition received by the end of 2003	\$500,000
Minus the sum of:	
Payment from 2000	\$100,000
Payment from 2001	100,000
Amount treated as received in 2001	<u>200,000</u>
Total on which gain was previously recognized	– 400,000
Payment on which gain is recognized for 2004	\$100,000
Multiply by gross profit %	× .50
Installment sale income for 2004	\$ 50,000

Exceptions to Rule 2. These rules do not apply to a second disposition, and any later transfer, if you can show to the satisfaction of the IRS that neither the first disposition (to the related person) nor the second disposition had as one of its principal purposes the avoidance of federal income tax. Generally, an involuntary second disposition will qualify under the nontax avoidance exception, such as when a creditor of the related person forecloses on the property or the related person declares bankruptcy.

The nontax avoidance exception also applies to a second disposition that is also an installment sale if the terms of payment under the installment resale are substantially equal to or longer than those for the first installment sale. However, the exception does not apply if the resale terms permit significant deferral of recognition of gain from the first sale.

In addition, any sale or exchange of stock to the issuing corporation is not treated as a first disposition. An involuntary conversion is not treated as a second disposition if the first disposition occurred before the threat of conversion. A transfer after the death of the person making the first disposition or the related person's death, whichever is earlier, is not treated as a second disposition.

Like-Kind Exchange

If you trade business or investment property solely for the same kind of property to be held as business or investment property, you can postpone reporting the gain. These trades are known as "like-kind exchanges." The property you receive in a like-kind exchange is treated as if it were a continuation of the property you gave up.

You do not have to report any part of your gain if you receive only like-kind property. However, if you also receive money or other property (boot) in the exchange, you must report your gain to the extent of the money and the FMV of the other property received.

For more information on like-kind exchanges, see *Like-Kind Exchanges* in chapter 1 of Publication 544.

Installment payments. If, in addition to like-kind property, you receive an installment obligation in the exchange, the following rules apply.

- 1) The contract price is reduced by the FMV 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.
- 3) Like-kind property received in the trade is not considered payment on the installment obligation.

Example. In 2001, George Brown trades personal property with an installment sale basis of \$400,000 for like-kind property having an FMV 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 2002 and the balance of \$700,000 (plus interest) in 2003.

George's selling price is \$1,000,000 (\$800,000 installment note + \$200,000 FMV of like-kind property received). His gross profit is \$600,000 (\$1,000,000 – \$400,000 installment sale basis). The contract price is \$800,000 (\$1,000,000 – \$200,000). The gross profit percentage is 75% (\$600,000 ÷ \$800,000). He reports no gain in 2001 because the like-kind property he receives is not treated as a payment for figuring gain. He reports \$75,000 gain for 2002 (75% of \$100,000 payment received) and \$525,000 gain for 2003 (75% of \$700,000 payment received).

Deferred exchanges. A deferred exchange is one in which you transfer property and receive like-kind property later. Under this type of exchange, the person receiving your property may be required to place funds in an escrow account or trust. If certain rules are met, these funds will not be considered a payment until you have the right to receive the funds or, if earlier, the end of the exchange period. See section 1.1031(k)-1(j)(2) of the regulations for these rules.

Contingent Payment Sale

For installment sales, a contingent payment sale is one whose total selling price cannot be determined by the end of the tax year in which the sale takes place.

If the selling price cannot be determined by the end of the tax year, the contract price and the gross profit percentage cannot be determined (using the same rules that apply to an installment sale with a fixed selling price). This happens, for example, if you sell your business and the selling price includes a percentage of its profits in future years.

For rules on using the installment method for a contingent payment sale or a contingent payment sale with unstated interest, see section 15A.453-1(c) of the regulations.

Single Sale of Several Assets

If you sell different types of assets in a single sale, you must identify each asset to determine whether you can use the installment method to report the sale of that asset. You also have to allocate part of the selling price to each asset. If you sell assets that constitute a trade or business, see *Sale of a Business*, next.

Unless an allocation of the selling price has been agreed to by both parties in an arm's-length transaction, you must allocate the

selling price to an asset based on its FMV. If the buyer assumes a debt, or takes the property subject to a debt, you must reduce the FMV of the property by the debt. This becomes the net FMV.

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 cannot be reported on the installment method. It must be reported separately. The remaining assets sold at a gain are reported together.

Example. You sold three separate and unrelated parcels of real property (A, B, and C) under a single contract calling for a total selling price of \$130,000. The total selling price consisted of a cash payment of \$20,000, the buyer's assumption of a \$30,000 mortgage on parcel B, and an installment obligation of \$80,000 payable in eight annual installments, plus interest at 8% a year.

Your installment sale basis for each parcel was \$15,000. Your net gain was \$85,000 (\$130,000 – \$45,000). You report the gain on the installment method.

The sales contract did not allocate the selling price or the cash payment received in the year of sale among the individual parcels. The FMV of parcels A, B, and C were \$60,000, \$60,000 and \$10,000, respectively.

Since the installment sale basis for parcel C was more than its FMV, it was sold at a loss and must be treated separately. You must allocate the total selling price and the amounts received in the year of sale between parcel C and the remaining parcels.

Of the total \$130,000 selling price, you must allocate \$120,000 to parcels A and B together and \$10,000 to parcel C. You should allocate the cash payment of \$20,000 received in the year of sale and the note receivable on the basis of their proportionate net FMV. The allocation is figured as follows:

	Parcels A and B	Parcel C
FMV	\$120,000	\$10,000
Minus: Mortgage assumed	30,000	-0-
Net FMV	\$ 90,000	\$10,000
Proportionate net FMV:		
Percentage of total	90%	10%
Payments in year of sale:		
\$20,000 × 90%	\$18,000	
\$20,000 × 10%		\$2,000
Excess of parcel B mortgage over installment sale basis	15,000	-0-
Allocation of payments received (or considered received) in year of sale	\$ 33,000	\$ 2,000

You cannot report the sale of parcel C on the installment method because the sale results in a loss. You report this loss of \$5,000 (\$10,000 selling price – \$15,000 installment sale basis) in the year of sale. However, if parcel C was held for personal use, the loss is not deductible.

You allocate the installment obligation of \$80,000 to the properties sold based on their proportionate net FMVs (90% to parcels A and B, 10% to parcel C).

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.

Allocation of selling price. The selling price must be allocated among each asset class for the following reasons.

- 1) The sale of a business generally includes real and personal property that can be reported on the installment method, and inventory items that cannot.
- 2) Depreciation recapture income from the sale of depreciable property cannot be reported on the installment method. It is reported in full in the year of the sale.
- 3) Assets sold at a loss cannot be reported on the installment method.

Inventory. 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 you receive payment in later years.

If inventory items are included in an installment sale, you may have an agreement stating which payments are for inventory and which are for the other assets being sold. If you do not, each payment must be allocated between the inventory and the other assets sold.

Report the amount you receive (or will receive) on the sale of inventory items as ordinary business income. Use your basis in the inventory to figure the cost of goods sold. Deduct the part of the selling expenses allocated to inventory as an ordinary business expense.

Residual method. 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 sale price to each business asset sold. This method determines gain or loss from the transfer of each asset and the buyer's basis in the assets.

The residual method must be used for any transfer of a group of assets that constitutes 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 or going concern value could, under any circumstances, attach to the assets or if the use of the assets would constitute an active trade or business under section 355 of the Internal Revenue code.

The residual method provides for the sale price to first be reduced by cash and general deposit accounts (including checking and savings accounts but excluding certificates of deposit and similar accounts) transferred by the seller. The consideration remaining after this reduction must be allocated among the various business assets in a certain order.

For asset acquisitions occurring **after January 5, 2000 and before March 16, 2001**, make the allocation among the following assets in the following order in proportion to (but not more than) their fair market value on the purchase date.

- 1) Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
- 2) Accounts receivable, mortgages, and credit card receivables that arose in the ordinary course of business.
- 3) Property of a kind that would properly be included in inventory if on hand at the end of the tax year and property held by the taxpayer primarily for sale to customers in the ordinary course of business.
- 4) All other assets except section 197 intangibles, goodwill, and going concern value.
- 5) Section 197 intangibles except goodwill and going concern value.
- 6) Goodwill and going concern value (whether or not they qualify as section 197 intangibles).

For asset acquisitions occurring **after March 15, 2001**, make the allocation in the following order among the following assets in proportion to (but not more than) their fair market value on the purchase date.

- 1) Certificates of deposit, U.S. Government securities, foreign currency, and actively traded personal property, including stock and securities.
- 2) Accounts receivable, other debt instruments, and assets that you mark to market at least annually for federal income tax purposes. However, see section 1.338-6(b)(2)(iii) of the regulations for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property.
- 3) Property of a kind that would properly be included in inventory if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business.
- 4) All other assets except section 197 intangibles.
- 5) Section 197 intangibles except goodwill and going concern value.
- 6) Goodwill and going concern value (whether or not they qualify as section 197 intangibles).

If an asset described in (1) through (6) is includible in more than one category, include it in the lower number category. For example, if an asset is described in both (4) and in (6) include it in (4).

More information. For information on the allocation of assets acquired after January 5, 2000 and before March 16, 2001, see *Sale of a Business* in chapter 2 of Publication 544. For more information on section 197 intangibles, see chapter 9 of Publication 535.

How to report the sale of a business. Both the seller and buyer must prepare and attach Form 8594, *Asset Acquisition Statement Under Sections 338 and 1060*, to their income tax return for the year the sale occurs. If the amount allocated to any asset is increased or decreased

after Form 8594 is filed, a supplemental statement in Part III of a new Form 8594 must be completed.

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 partner must allocate a portion of the proceeds to ordinary income if the partnership's assets include unrealized receivables and inventory items. (The term "unrealized receivables" includes depreciation recapture income, discussed earlier.)

The gain allocated to the unrealized receivables and the inventory cannot be reported under the installment method. The gain allocated to the other assets can be reported under the installment method.

For more information on the treatment of unrealized receivables and inventory, see Publication 541.

Example

On June 4, 2001, you sold the machine shop you had operated since 1990. You received a \$100,000 down payment and the buyer's note for \$120,000. The note payments are \$15,000 each, plus 10% interest, due every July 1 and January 1, beginning in 2002. The total selling price is \$220,000. Your selling expenses are \$11,000. The selling expenses are divided among all the assets sold, including inventory.

Your selling expense for each asset is 5% of the asset's selling price (\$11,000 selling expense ÷ \$220,000 total selling price).

The FMV, adjusted basis, and depreciation claimed on each asset sold are as follows:

Asset	FMV	Depreciation Claimed	Adjusted Basis
Inventory	\$ 10,000	-0-	\$ 8,000
Land	42,000	-0-	15,000
Building	48,000	\$ 9,000	36,000
Machine A	71,000	27,200	63,800
Machine B	24,000	12,960	22,040
Truck	6,500	18,624	5,376
	\$201,500	\$67,784	\$150,216

Under the residual method, you allocate the selling price to each of the assets based on their FMV (\$201,500). The remaining amount is allocated to your section 197 intangible, goodwill (\$18,500).

The assets included in the sale, their selling prices based on their FMVs, the selling expense allocated to each asset, the adjusted basis, and the gain for each asset are shown in the following chart.

	Sale Price	Sale Exp.	Adj. Basis	Gain
Inventory	\$ 10,000	\$ 500	\$ 8,000	\$ 1,500
Land	42,000	2,100	15,000	24,900
Building	48,000	2,400	36,000	9,600
Mch. A	71,000	3,550	63,800	3,650
Mch. B	24,000	1,200	22,040	760
Truck	6,500	325	5,376	799
Goodwill	18,500	925	-0-	17,575
	\$220,000	\$11,000	\$150,216	\$58,784

The building was acquired in 1990, the year the business began, and it is section 1250 property. There is no depreciation recapture income because the building was depreciated using the straight line method.

All gain on the truck, machine A, and machine B is depreciation recapture income since it is the lesser of the depreciation claimed or the gain on the sale. Figure depreciation recapture in Part III of Form 4797.

The total depreciation recapture income reported in Part II of Form 4797 is \$5,209. This consists of \$3,650 on machine A, \$799 on the truck, and \$760 on machine B (the gain on each item since it was less than the depreciation claimed). These gains are reported in full in the year of sale and are not included in the installment sale computation.

Of the \$220,000 total selling price, the \$10,000 for inventory assets cannot be reported on the installment method. The selling prices of the truck and machines are also removed from the total selling price because gain on these items is reported in full in the year of sale.

The selling price equals the contract price for the installment sale (\$108,500). The assets included in the installment sale, their selling price, and their installment sale bases are shown in the following chart.

	Selling Price	Installment Sale Basis	Gross Profit
Land	\$ 42,000	\$17,100	\$24,900
Building	48,000	38,400	9,600
Goodwill	18,500	925	17,575
Total	\$108,500	\$56,425	\$52,075

The **gross profit percentage** (gross profit ÷ contract price) for the installment sale is 48% (\$52,075 ÷ \$108,500). The gross profit percentage for each asset is figured as follows:

	Percentage
Land—\$24,900 ÷ \$108,500	22.95
Building—\$9,600 ÷ \$108,500	8.85
Goodwill—\$17,575 ÷ \$108,500	16.20
Total	48.00

Since the sale includes assets sold on the installment method and assets for which the gain is reported in full in the year of sale, payments must be allocated between the installment part of the sale and the part reported in the year of sale. The selling price for the installment sale is \$108,500. This is 49.3% of the total selling price of \$220,000 (\$108,500 ÷ \$220,000). The selling price of assets not reported on the installment method is \$111,500. This is 50.7% (\$111,500 ÷ \$220,000) of the total selling price.

Multiply principal payments by 49.3% to determine the part of the payment for the installment sale. The balance, 50.7%, is for the part reported in the year of the sale.

The gain on the sale of the inventory, machines, and truck is reported in full in the year of sale. When you receive principal payments in later years, no part of the payment for the sale of these assets is included in gross income. Only the part for the installment sale (49.3%) is used in the installment sale computation.

The only payment received in 2001 is the down payment of \$100,000. The part of the payment for the installment sale is \$49,300 (\$100,000 × 49.3%). This amount is used in the installment sale computation.

Installment income for 2001. Your installment income for each asset is the gross profit percentage for that asset times \$49,300, the installment income received in 2001.

	Income
Land—22.95% of \$49,300	\$11,314
Building—8.85% of \$49,300	4,363
Goodwill—16.2% of \$49,300	7,987
Total installment income for 2001	\$23,664

Installment income after 2001. You figure installment income for years after 2001 by applying the same gross profit percentages to 49.3% of the total payments you receive on the buyer's note during the year.

Unstated Interest and Original Issue Discount

Note: Section references are to the Internal Revenue Code and regulation references are to the Income Tax Regulations under the Code.

An installment sale contract generally provides that each deferred payment on the sale will include interest or there will be an interest payment in addition to the principal payment. Interest provided in the contract is called **stated interest**.

If an installment sale contract does not provide for adequate stated interest, part of the stated principal amount of the contract may be recharacterized as interest. If section 483 applies to the contract, this interest is called **unstated interest**. If section 1274 applies to the contract, this interest is called **original issue discount (OID)**.

An installment sale contract does not provide for adequate stated interest if the stated interest rate is lower than the test rate (defined later).

Treatment of unstated interest and OID. Generally, the unstated interest rules do not apply to a debt given in consideration for a sale or exchange of personal-use property. Personal-use property is any property in which substantially all of its use by the buyer is not in connection with a trade or business or an investment activity.

Rules for the seller. If either section 1274 or section 483 applies to the installment sale contract, you must treat part of the installment sale price as interest, even though interest is not called for in the sales agreement. If either section applies, you must reduce the stated selling price of the property and increase your interest income by this interest.

Include the unstated interest in income based on your regular method of accounting. Include OID in income over the term of the contract.

The OID includible in income each year is based on the constant yield method described in section 1272. (In some cases, the OID on an installment sale contract may also include all or part of the stated interest, especially if the stated interest is not paid at least annually.)

If you do not use the installment method to report the sale, report the entire gain under your method of accounting in the year of sale. Reduce the selling price by any stated principal treated as interest to determine the gain.

Report unstated interest or OID on your tax return, in addition to stated interest.

Rules for the buyer. Any part of the stated selling price of an installment sale contract treated by the buyer as interest reduces the buyer's basis in the property and increases the buyer's interest expense. These rules do not apply to personal-use property (for example, property not used in a trade or business).

Adequate stated interest. An installment sale contract generally provides for adequate stated interest if the contract's stated principal amount is at least equal to the sum of the present values of all principal and interest payments called for under the contract. The present value of a payment is determined based on the test rate of interest, defined next. (If section 483 applies to the contract, payments due within six months after the sale are taken into account at face value.) In general, an installment sale contract provides for adequate stated interest if the stated interest rate (based on an appropriate compounding period) is at least equal to the test rate of interest.

Test rate of interest. The test rate of interest for a contract is the 3-month rate. The 3-month rate is the **lower** of the following applicable federal rates (AFRs).

- The lowest AFR (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there is a binding written contract that substantially provides the terms under which the sale or exchange is ultimately completed.
- The lowest AFR (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

Applicable federal rate (AFR). The AFR depends on the month the binding contract for the sale or exchange of property is made and the term of the instrument. For an installment obligation, the term of the instrument is its weighted average maturity, as defined in section 1.1273-1(e)(3) of the regulations. The AFR for each term is shown below.

- For a term of 3 years or less, the AFR is the federal short-term rate.
- For a term of over 3 years, but not over 9 years, the AFR is the federal mid-term rate.
- For a term of over 9 years, the AFR is the federal long-term rate.



The applicable federal rates are published monthly in the Internal Revenue Bulletin (IRB). You can get this information by contacting an IRS office. IRBs are also available on the IRS web site at www.irs.gov.

Seller financed sales. For sales or exchanges of property (other than new section 38 property, which includes most tangible personal property) involving seller financing of \$4,085,900 or less, the test rate of interest cannot be more than 9%, compounded semiannually. For seller financing over \$4,085,900 and for all sales or exchanges of new section 38 property, the test rate of interest is 100% of the AFR.

For information on new section 38 property, see section 48(b) of the Internal Revenue Code, as in effect before the enactment of Public Law 101-508.

Certain land transfers between related persons. In the case of certain land transfers between related persons (described later), the test

rate is no more than 6 percent, compounded semiannually.

Internal Revenue Code sections 1274 and 483. If an installment sale contract does not provide for adequate stated interest, generally either section 1274 or section 483 will apply to the contract. These sections recharacterize part of the stated principal amount as interest. Whether either of these sections apply to a particular installment sale contract depends on several factors, including the total selling price and the type of property sold.

Section 1274. Section 1274 applies to a debt instrument issued for the sale or exchange of property if any payment under the instrument is due more than 6 months after the date of the sale or exchange and the instrument does not provide for adequate stated interest. Section 1274, however, does not apply to an installment sale contract that is a cash method debt instrument (defined next) or that arises from the following transactions.

- A sale or exchange for which the total payments are \$250,000 or less.
- The sale or exchange of an individual's main home.
- The sale or exchange of a farm for \$1,000,000 or less by an individual, an estate, a testamentary trust, small business corporation (defined in section 1244(c)(3)), or a domestic partnership that meets requirements similar to those of section 1244(c)(3).
- Certain land transfers between related persons (described later).

Cash method debt instrument. This is any debt instrument given as payment for the sale or exchange of property (other than new section 38 property) with a stated principal of \$2,918,500 or less if the following items apply.

- 1) The lender (holder) does not use an accrual method of accounting and is not a dealer in the type of property sold or exchanged.
- 2) Both the borrower (issuer) and the lender jointly elect to account for interest under the cash method of accounting.
- 3) Section 1274 would apply except for the election in (2) above.

Land transfers between related persons. The section 483 rules (discussed next) apply to debt instruments issued in a land sale between related persons to the extent the **sum** of the following amounts does not exceed \$500,000.

- The stated principal of the debt instrument issued in the sale or exchange.
- The total stated principal of any other debt instruments for prior land sales between these individuals during the calendar year.

The section 1274 rules, if otherwise applicable, apply to debt instruments issued in a sale of land to the extent the stated principal amount exceeds \$500,000, or if any party to the sale is a nonresident alien.

Related persons include an individual and the members of the individual's family and their spouses. Members of an individual's family include the individual's spouse, brother and sister

(whole or half), ancestors, and lineal descendants.

Section 483. Section 483 generally applies to an installment sale contract that does not provide for adequate stated interest and is not covered by section 1274. Section 483, however, generally does not apply to an installment sale contract that arises from the following transactions.

- A sale or exchange for which no payments are due more than one year after the date of the sale or exchange.
- A sale or exchange for \$3,000 or less.

Exceptions to sections 1274 and 483. Sections 1274 and 483 do not apply under the following circumstances.

- An assumption of a debt instrument in connection with a sale or exchange or the acquisition of property subject to a debt instrument, unless the terms or conditions of the debt instrument are modified in a manner that would constitute a deemed exchange under section 1.1001-3 of the regulations.
- A debt instrument issued in connection with a sale or exchange of property if either the debt instrument or the property is publicly traded.
- A sale or exchange of all substantial rights to a patent, or an undivided interest in property that includes part or all substantial rights to a patent, if any amount is contingent on the productivity, use, or disposition of the property transferred. See Publication 544 for more information.
- An annuity contract issued in connection with a sale or exchange of property if the contract is described in section 1275(a)(1)(B) of the Code and section 1.1275-1(j) of the regulations.
- A transfer of property subject to section 1041 of the Code (relating to transfers of property between spouses or incident to divorce).
- A demand loan that is a below-market loan described in section 7872(c)(1) of the Code (for example, gift loans and corporation-shareholder loans).
- A below-market loan described in section 7872(c)(1) of the Code issued in connection with the sale or exchange of personal-use property. This rule applies only to the holder.

Determining whether section 1274 or section 483 applies. For purposes of determining whether either section 1274 or section 483 applies to an installment sale contract, all sales or exchanges that are part of the same transaction (or related transactions) are treated as a single sale or exchange and all contracts arising from the same transaction (or a series of related transactions) are treated as a single contract. Also, the total consideration due under an installment sale contract is determined at the time of the sale or exchange. Any payment (other than a debt instrument) is taken into account at its FMV.

More information. For information on figuring unstated interest and OID and other special rules, see sections 1274 and 483 of the Internal Revenue Code and the related regulations. In the case of an installment sale contract that provides for contingent payments, see sections 1.1275-4(c) and 1.483-4 of the regulations.

Disposition of an Installment Obligation

A disposition generally includes a sale, exchange, cancellation, bequest, distribution, or transmission of an installment obligation. An "installment obligation" is the buyer's note, deed of trust, or other evidence the buyer will make future payments to you.

If you are using the installment method and you dispose of the installment obligation, generally you will have a gain or loss to report. It is considered gain or loss on the sale of the property for which you received the installment obligation. If the original installment sale 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.

Use the following rules to figure your gain or loss from the disposition of an installment obligation.

- 1) If you **sell or exchange the obligation**, or you accept less than face value in satisfaction of the obligation, the gain or loss is the difference between your basis in the obligation and the amount you realize.
- 2) If you **dispose of the obligation in any other way**, the gain or loss is the difference between your basis in the obligation and its FMV at the time of the disposition. This rule applies, for example, when you give the installment obligation to someone else or cancel the buyer's debt to you.

Basis. Figure your basis in an installment obligation by multiplying the unpaid balance on the obligation by your gross profit percentage. Subtract that amount from the unpaid balance. The result is your basis in the installment obligation.

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

Transfer 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. 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 of the transferred obligation applies to the transferee spouse or former spouse as would have 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.

The nonrecognition rule does not apply if the spouse or former spouse receiving the obligation is a nonresident alien.

Gift. A gift of an installment obligation is a disposition. The gain or loss is the difference between your basis in the obligation and its FMV at the time you make the gift.

For gifts between spouses or former spouses, see *Transfers between spouses or former spouses*, earlier.

Cancellation. If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. Your gain or loss is the difference between your basis in the obligation and its FMV at the time you cancel it. If the parties are related, the FMV of the obligation is considered to be no less than its full face value.

Forgiving part of the buyer's debt. If you accept part payment on the balance of the buyer's installment debt to you and forgive the rest of the debt, you treat the settlement as a disposition of the installment obligation. The gain or loss is the difference between your basis in the obligation and the amount you realize on the settlement.

If you reduce the selling price but do not cancel the rest of the buyer's debt to you, it is not considered a disposition of the installment obligation. You must refigure the gross profit percentage and apply it to payments you receive after the reduction. See *Selling price reduced under General Rules*, earlier.

Assumption. If the buyer of your property sells it to someone else and you agree to let the new buyer assume the original buyer's installment obligation, you have not disposed of the installment obligation. It is not a disposition even if the new buyer pays you a higher rate of interest than the original buyer.

Transfer due to death. The transfer of an installment obligation (other than to a buyer) as a result of the death of the seller is not a disposition. Any unreported gain from the installment obligation is not treated as gross income to the decedent. No income is reported on the decedent's return due to the transfer. Whoever receives the installment obligation as a result of the seller's death is taxed on the installment payments the same as the seller would have been had the seller lived to receive the payments.

However, if an installment obligation is canceled, becomes unenforceable, or is 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 FMV of the installment obligation is considered to be no less than its full face value.

Repossession

If you repossess your property after making an installment sale, you must figure the following amounts.

- 1) Your gain (or loss) on the repossession.
- 2) Your basis in the repossessed property.

The rules for figuring these amounts depend on the kind of property you repossess. The rules for repossessions of personal property differ from those for real property. Special rules may

apply if you repossess property that was your main home before the sale.

The repossession rules apply whether or not title to the property was ever transferred to the buyer. It does not matter how you repossess the property, whether you foreclose or the buyer voluntarily surrenders the property to you. However, it is not a repossession if the buyer puts the property up for sale and you repurchase it.

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to you. The discharged obligation must be secured by the property you repossess. This requirement is met if the property is auctioned off after you foreclose and you apply the installment obligation to your bid price at the auction.

Reporting the repossession. You report gain or loss from a repossession on the same form you used to report the original sale. If you reported the sale on Form 4797, use it to report the gain or loss on the repossession.

Personal Property

If you repossess personal property, you may have a gain or a loss on the repossession. In some cases, you may also have a bad debt.

To figure your gain or loss, subtract the total of your basis in the installment obligation and any repossession expenses you have from the FMV of the property. If you receive anything from the buyer besides the repossessed property, add its value to the property's FMV before making this calculation.

How you figure your basis in the installment obligation depends on whether or not you reported the original sale on the installment method. The method you used to report the original sale also affects the character of your gain or loss on the repossession.

Sales not reported on the installment method: See *Electing Out of the Installment Method*, earlier.

Basis in installment obligation. Your basis is figured on the obligation's full face value or its FMV at the time of the original sale, whichever you used to figure your gain or loss in the year of sale. From this amount, subtract all payments of principal you have received on the obligation. The result is your basis in the installment obligation. If only part of the obligation is discharged by the repossession, figure your basis in only that part.

Gain or loss. Add any repossession costs to your basis in the obligation. If the FMV of the property you repossess is more than this total, you have a gain. Because it is gain on the installment obligation, it is all ordinary income. If the FMV of the repossessed property is less than the total of your basis plus repossession costs, you have a loss. Because you included the full gain in income in the year of sale, the loss is a bad debt. How you deduct the bad debt depends on whether you sold business or nonbusiness property in the original sale. See Publication 550 for information on nonbusiness bad debts and chapter 11 of Publication 535 for information on business bad debts.

Sales reported on the installment method:

Basis in installment obligation. Multiply the unpaid balance of your installment obligation by your gross profit percentage. Subtract that amount from the unpaid balance. The result is your basis in the installment obligation.

Gain or loss. If the FMV of the repossessed property is more than the total of your basis in the obligation plus any repossession costs, you have a gain. If the FMV is less, you have a loss. Your gain or loss on the repossession is of the same character (capital or ordinary) as your gain on the original sale.



Use the following worksheet to determine the taxable gain or loss on a repossession of personal property reported on the installment method.

1) FMV of property repossessed	_____
2) Unpaid balance of installment obligation	_____
3) Unrealized profit (line 2 × gross profit %)	_____
4) Basis of obligation (line 2 – line 3)	_____
5) Plus: Repossession costs	_____
6) Gain or loss on repossession (line 1 – line 5)	=====

Example. You sold your piano for \$1,500 in December 2000 for \$300 down and \$100 a month (plus interest). The payments began in January 2001. Your gross profit percentage is 40%. You reported the sale on the installment method on your 2000 income tax return. After the fourth monthly payment, the buyer defaulted on the contract (which has an unpaid balance of \$800) and you are forced to foreclose on the piano. The FMV of the piano on the date of repossession is \$1,400. The legal costs of foreclosure and the expense of moving the piano back to your home total \$75. You figure your gain on the repossession as follows:

1) FMV of property repossessed	\$1,400
2) Unpaid balance of installment obligation	\$800
3) Unrealized profit (line 2 × gross profit %)	320
4) Basis of obligation (line 2 – line 3)	480
5) Plus: Repossession costs	75
6) Gain on repossession (line 1 – line 5)	\$ 845

Basis in repossessed property. Your basis in repossessed personal property is its FMV at the time of the repossession.

Fair market value (FMV). The FMV of repossessed property is a question of fact to be established in each case. If you bid for the property at a lawful public auction or judicial sale, its FMV is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

Real Property

The rules for the repossession of real property allow you to keep essentially the same adjusted basis in the repossessed property you had before the original sale. You can recover this entire adjusted basis when you resell the property. This, in effect, cancels out the tax treatment that applied to you on the original sale and puts

you in the same tax position you were in before that sale.

Therefore, the total payments you have received from the buyer on the original sale must be considered income to you. You report, as gain on the repossession, any part of the payments you have not yet included in income. These payments are amounts you previously treated as a return of your adjusted basis and excluded from income. However, the total gain you report is limited. See *Limit on taxable gain*, discussed later.

Mandatory rules. The rules concerning basis and gain on repossessed real property are mandatory. You must use them to figure your basis in the repossessed real property and your gain on the repossession. They apply whether or not you reported the sale on the installment method. However, they apply only if *all* the following conditions are met.

- 1) The repossession must be to protect your security rights in the property.
- 2) The installment obligation satisfied by the repossession must have been received in the original sale.
- 3) You cannot pay any additional consideration to the buyer to get your property back, unless either of the situations listed below apply.
 - a) The requisition and payment of the additional consideration were provided for in the original contract of sale.
 - b) The buyer has defaulted, or default is imminent.

“Additional consideration” includes money and other property you pay or transfer to the buyer. For example, additional consideration is paid if you reacquire the property subject to a debt that arose after the original sale.

Conditions not met. If any one of these three conditions is not met, use the rules discussed under *Personal Property*, earlier, as if the property you repossess were personal rather than real property. Do not use the rules for real property.

Figuring gain on repossession. Your gain on repossession is the difference between the following amounts.

- 1) The total payments received, or considered received, on the sale.
- 2) The total gain already reported as income.

See the earlier discussions under *Payments Received* for items considered payment on the sale.

Limit on taxable gain. Taxable gain is limited to your gross profit on the original sale minus the sum of the following amounts.

- 1) The gain on the sale you reported as income before the repossession.
- 2) Your repossession costs.

This method of figuring taxable gain, in essence, treats all payments received on the sale as income, but limits your total taxable gain to the gross profit you originally expected on the sale.

Indefinite selling price. The limit on taxable gain does not apply if the selling price is indefinite and cannot be determined at the time of repossession. For example, a selling price stated as a percentage of the profits to be realized from the buyer’s development of the property is an indefinite selling price.

Character of gain. The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if you did not report the sale on the installment method, the gain is ordinary income.

Repossession costs. Your repossession costs include money or property you pay to reacquire the real property. This includes amounts paid to the buyer of the property, as well as amounts paid to others for such items as those listed below.

- 1) Court costs and legal fees.
- 2) Publishing, acquiring, filing, or recording of title.
- 3) Lien clearance.

Repossession costs do not include the FMV of the buyer’s obligations to you that are secured by the real property or the costs of reacquiring those obligations.



Use the following worksheet to determine the taxable gain on a repossession of real property reported on the installment method.

1) Payments received before repossession	_____
2) Minus: Gain reported	_____
3) Gain on repossession	=====
4) Gross profit on sale	_____
5) Gain reported (line 2)	_____
6) Plus: Repossession costs	_____
7) Subtract line 6 from line 4	=====
8) Taxable gain (lesser of line 3 or 7)	=====

Example. You sold a tract of land in January 1999 for \$25,000. You accepted a \$5,000 down payment, plus a \$20,000 mortgage secured by the property and payable at the rate of \$4,000 annually plus interest (9.5%). The payments began on January 1, 2000. Your adjusted basis in the property was \$19,000 and you reported the transaction as an installment sale. Your selling expenses were \$1,000. You figured your gross profit as follows:

Selling price	\$25,000
Minus:	
Adjusted basis	\$19,000
Selling expenses	1,000
Gross profit	\$ 5,000

For this sale, the contract price equals the selling price. The gross profit percentage is 20% (\$5,000 gross profit ÷ \$25,000 contract price).

In 1999, you included \$1,000 in income (20% × \$5,000 down payment). In 2000, you reported a profit of \$800 (20% × \$4,000 annual installment). In 2001, the buyer defaulted and you repossessed the property. You paid \$500 in legal fees to get your property back. Your taxable gain on the repossession is figured as follows:

1) Payments received before repossession	\$9,000
2) Minus: Gain reported	<u>1,800</u>
3) Gain on repossession	<u>\$7,200</u>
4) Gross profit on sale	\$5,000
5) Gain reported (line 2)	<u>\$1,800</u>
6) Plus: Repossession costs	<u>500</u> 2,300
7) Subtract line 6 from line 4	<u>\$2,700</u>
8) Taxable gain (lesser of line 3 or 7)	<u>\$2,700</u>

Basis. Your basis in the repossessed property is determined as of the date of repossession. It is the sum of the following amounts.

- 1) Your adjusted basis in the installment obligation.
- 2) Your repossession costs.
- 3) Your taxable gain on the repossession.

To figure your adjusted basis in the installment obligation at the time of repossession, multiply the unpaid balance by the gross profit percentage. Subtract that amount from the unpaid balance.



Use the following worksheet to determine the basis of real property repossessed.

1) Unpaid balance of obligation	_____
2) Minus: Unrealized profit (line 1 × gross profit %)	_____
3) Adjusted basis (date of repossession)	_____
4) Plus: Taxable gain on repossession	_____
Repossession costs	_____
5) Basis of repossessed real property	=====

Example. Assume the same facts as in the preceding example. The unpaid balance of the installment obligation (the \$20,000 note) is \$16,000 at the time of repossession because the buyer made a \$4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, \$3,200 (20% × \$16,000 still due on the note) is unrealized profit. You figure your basis in the repossessed property as follows:

Unpaid balance of obligation	\$16,000
Minus: Unrealized profit	<u>3,200</u>
Adjusted basis (date of repossession)	\$12,800
Plus: Taxable gain on repossession	\$2,700
Repossession costs	<u>500</u> 3,200
Basis of repossessed real property	<u>\$16,000</u>

Holding period for resales. If you resell the repossessed property, the resale may result in a capital gain or loss. To figure whether the gain or loss is long-term or short-term, your holding period includes the period you owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property.

If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession.

Bad debt. If you repossess real property under these rules, you cannot take a bad debt deduction for any part of the buyer's installment obligation. This is true even if the obligation is not fully satisfied by the repossession.

If you took a bad debt deduction before the tax year of repossession, you are considered to have recovered the bad debt when you repossess the property. You must report the bad debt deduction taken in the earlier year as income in the year of repossession. However, if any part of

the earlier deduction did not reduce your tax, you do not have to report that part as income. Your adjusted basis in the installment obligation is increased by the amount you report as income from recovering the bad debt.

Reporting an Installment Sale

Form 6252. Use Form 6252 to report a sale of property on the installment method. The form is used to report the sale in the year it takes place and to report payments received in later years. Also, if you sold property to a related person, you may have to file the form each year until the installment debt is paid off, whether or not you receive a payment in that year.

Related person. If you sell marketable securities to a related person, complete Part III, Form 6252, for each year of the installment agreement, even if you do not receive a payment in that year.

If you sell property other than marketable securities to a related person, complete Part III for the year of sale and the 2 years following the year of sale, even if you do not receive a payment. After this 2-year period, you do not have to fill out Part III.

If the related person to whom you sold your property disposes of it, you may have to immediately report the rest of your gain in Part III. See *Rule 2—Sale and Resale under Sale to a Related Person*, earlier, for more information.

Several assets. If you sell two or more assets in one installment sale, you may have to separately report the sale of each asset. The same is true if you sell all the assets of your business in one installment sale. See *Single Sale of Several Assets* and *Sale of a Business*, earlier.

If you have only a few sales to separately report, use a separate Form 6252 for each one. However, if you have to separately report the sale of multiple assets that you sold together, prepare only one Form 6252 and attach a schedule with all the information for each asset that is required by Form 6252. Complete Form 6252 by following the steps listed below.

- 1) Answer the questions at the top of the form.
- 2) In the year of sale, do not complete Part I. Instead, write "See attached schedule" in the margin.
- 3) For Part II, enter the total for all the assets on lines 24, 25, and 26.
- 4) For Part III, answer all the questions that apply. If none of the exceptions under question 29 apply, enter the totals on lines 35, 36, and 37 for the disposed assets.

Special situations. If you are reporting payments from an installment sale as income in respect of a decedent or as a beneficiary of a trust, including a partial interest in such a sale, you may not be able to provide all the information asked for on Form 6252. To the extent possible, follow the instructions given above and provide as many details as possible in a statement attached to Form 6252.

For more information on how to complete Form 6252, see the form instructions.

Other forms. The gain from Form 6252 is carried over and entered on Schedule D (Form 1040), *Capital Gains and Losses*, Form 4797, *Sales of Business Property*, or both. These forms were discussed earlier under *Reporting Installment Income*.

Schedule D (Form 1040). Although the references in this publication are to the Schedule D for Form 1040, the rules discussed also apply to Schedule D for Forms 1041 (estates and trusts), 1065 (partnerships), 1120 or 1120-A (corporations), and 1120S (S corporations).

Form 4797. Form 4797 is used with estate and trust, partnership, corporation, and S corporation returns, as well as individual returns.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at www.irs.gov. While visiting our web site, you can:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.

- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at <ftp.irs.gov>.



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.

- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistant and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistants objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



Walk-in. You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county govern-

ments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at www.irs.gov. The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676** or visiting the IRS web site at www.irs.gov.

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