

Chapter 12.

Installment Contracts

GENERAL PROVISIONS

If certain conditions are met, the gain recognized on an installment sale of real property can be spread over the duration of the contract for income tax purposes. An outright sale, on the other hand, triggers immediate recognition of all gain in the year of sale for income tax purposes. Although the 1987 Revenue Act repealed the installment sale method of reporting for dealers in real and personal property, it specifically exempted sales of property used or produced in the trade or business of farming as defined in Sections 2032A(4) and (5) of the Internal Revenue Code (IRC) (see chapter 13). This definition of farming includes timber growing.

In addition to the income tax advantages, installment sales can also be a good estate planning tool. Their use has become much more prevalent in recent years for facilitating the lifetime transfer of farm and forest property to succeeding generations, while deferring recognition of gain to future years.

Basic Requirements

The former requirements that an installment obligation must have two or more payments spread out over at least 2 tax years and that the payment(s) in the year of sale not exceed 30 percent of the selling price were repealed in 1980. Now the installment method of reporting gain is available when at least one payment is to be received after the close of the taxable year in which the sale occurs. No payment is required in the year of sale, although one or more can be made. The installment method is available only for reporting gains; losses cannot be deferred but must be recognized in the tax year of the sale.

Payments in the Year of Sale.--Payments in the year of sale include down payments made in a prior year as well as payments received in the year that the benefits and burdens of ownership pass to the buyer. This is usually the year of transfer of possession, or the year of title passage, whichever occurs first.

Example 12.1. Suppose a forest landowner agrees to sell his tree farm for \$150,000 and receives a down payment of 2,000 on September 15, 1992.

The first installment payment of \$25,000 is received on April 30, 1993, and possession is given to the buyer at that time. A total payment of \$27,000 is reportable as income by the seller in 1993.

Restrictions

Certain restrictions on the use of installment sales should be noted. For example, a sale of depreciable property between related persons, as defined in Section 1239(b) of the IRC, cannot be reported by the installment method unless it is established that the transaction did not have as one of its principal purposes the avoidance of taxation. Another restriction governs the sale of nondepreciable property between related parties and then a resale by the purchaser. If the purchaser, in turn, sells the property before the installment payments are made in full, the amount realized by the related party second seller from the second disposition is treated as being received by the initial seller at that time. In other words, the first seller's gain is accelerated to the extent of the payment received by the second seller. In many cases, however, because of the specific provisions governing the resale rule, the related party restrictions will not apply if the second sale takes place more than 2 years after the first. A related person includes a spouse, child, grandchild, parent, grandparent, brother, and sister; and corporations, partnerships, and estates that are 80 percent or more owned by such persons.

Mechanics of the Election

If the eligibility requirements discussed above are met, the installment method of reporting income is automatic for sales of real property and casual sales of personal property unless the taxpayer elects out of such a reporting method. This "negative" election recognizes that almost all taxpayers prefer the installment method of reporting income when possible. An election not to use the installment method must be made on or before the due date, including extensions, for filing the taxpayer's return for the tax year in which the installment sale occurs.

Computing the Gain

In order to compute the portion of each installment payment that will be reported as gain, the selling price (the contract price) and the gross profit must be determined. The selling price includes the amount of the down payment, the face value of the installment obligations, and the amount of any liability or indebtedness that the purchaser assumes. Gross profit is the difference between the selling price and the seller's basis in the property. The contract price is the selling price less the amount of liabilities or indebtedness assumed by the purchaser. However, if the liabilities or indebtedness exceeds the seller's basis, the excess is not subtracted from the selling price to calculate the contract price. Once the gross profit and contract price have been calculated, the percentage of each payment to be reported as gain is determined by dividing the gross profit by the contract price. The following example illustrates the computation procedures:

Example 12.2. The taxpayer decides to sell 150 acres of timberland on the installment method and enters into an agreement providing for a \$20,000 down payment, annual installments of \$7,000 each over a period of 10 years, a final balloon payment of \$25,000, and assumption by the purchaser of a \$65,000 mortgage. The taxpayer's basis in the property is \$50,000 and sale expenses are \$5,000. The calculations are as follows:

Selling price	
Down payment	\$ 20,000
Total annual installments	70,000
Balloon payment	25,000
Assumption of mortgage	<u>65,000</u>
Selling price	\$180,000
Gross profit	
Selling price	\$180,000
Adjusted basis	<u>- 50,000</u>
Gross profit	130,000
Sale expenses	<u>- 5,000</u>
Gross profit to be realized	\$125,000
Contract price	
Selling price	\$180,000
Mortgage assumed	<u>- 65,000</u>
Subtotal	115,000
Mortgage exceeds basis	<u>+ 15,000</u>
Total (contract price)	\$130,000

The percentage gain on each payment is:

$$\$125,000/\$130,000=96.2\%.$$

ESTATE PLANNING CONSIDERATIONS

Advantages

An installment sale contract may be an ideal tool for parents to use if they wish to begin lifetime transfers of forest land to their children. Such contracts may be particularly attractive to a surviving spouse wanting to avoid heavy involvement in management of the tree farm. In this regard, the following can be accomplished: (1) an interest in the property as security can be retained by keeping the title, (2) a steady, annual income can be received for the duration of the contract--with income not subject to the social security tax or reducing social security benefits, (3) management responsibility can be transferred to the children, (4) an opportunity for the children to acquire an interest in the property with a low down payment can be provided, (5) the size of the estate can be reduced by consuming or making gifts of the installment payments received, and (6) because the contract value is fixed, further increases in value after the contract is signed will not increase the size of the estate.

Disadvantages

There may also be certain disadvantages associated with an installment sale from parents to children that should be considered. For example, the parents may outlive the term of the contract and then have to depend on other sources of income. Inflation may elevate the parents' cost of living to a point where they will have difficulty living on the fixed-contract payments. Although an installment contract reduces the uncertainty of available annual income, it increases the uncertainty of outliving one's assets.

Other Considerations

It is necessary to give careful consideration to establishing the price and terms in an installment sale in order to further the objectives of transferring future appreciation out of the parent's estates, and facilitating transfer of ownership and management control from one generation to the next. If the price is too high or the terms too inflexible, the purchaser may be unable to meet the payments. If the price is too low, the transaction may be characterized as part sale and part gift, thus making the sale subject to gift tax as well as income tax.

If the parents are concerned that the child (children) purchasing the tree farm will have difficulty in generating a sufficient cash flow to finance the purchase, they may wish to establish a selling price below market value. The danger of this, however, is that transfers for inadequate consideration will be treated as gifts to the extent that the fair market value of the property exceeds the sale price. Because transfers of property between family members will be carefully scrutinized to determine whether a gift has occurred, unless a gift is intended the parties must structure the sale to insure that it has the characteristics of a business transaction.

Although many court decisions suggest that the sale need not be at the top of the market in order to avoid characterization as a gift, the parties should proceed with caution. Because the gift tax statute of limitations does not begin to run until a gift tax return is filed, there is always the danger that the IRS will examine the transaction many years later, perhaps during an estate tax audit, and contend that the sale was in fact a gift. For that reason, it might be advisable, if the sale is substantially below market, to file a gift tax return at the time of transfer.

Use of Installment Sales to Facilitate Gifts

On the other hand, an installment sale may facilitate the gifting of forest property by making it possible for the parents to convey the woodland to a child or children and avoid the gift tax by keeping annual gifts to each child within the \$20,000 split gift tax exclusion amount. For example, if the parents have already used their unified credit against gift taxes and wish to give the tree farm to their children, the value of the gift in excess of \$20,000 per child would be subject to gift tax. If the parents wished to stay within the \$20,000 limit, they would have to convey the property a few acres at a time or give small fractional interests, neither of which are very suitable alternatives. An installment sale, however, can provide a vehicle for immediate transfer of the woodland to the children while making it possible for the parents to stay within the exclusion amount for each child.

For example, the property may be conveyed in exchange for \$10,000 principal amount, interest-bearing notes, payable semiannually. If the parents wish to make a gift to the acquiring child, they may forgive the notes as they become due. Caution must be exercised, however, so that the IRS will

not contend that a gift of the entire value of the property occurred in the year of sale. There should be no problem if the notes are legally enforceable and subject to assignment or sale to third parties, if the property is subject to foreclosure in the event of default, and if the parents have no legal obligation to make annual gifts to the children [see *Estate of Kelley*, 63 TC 321 (1974); and *Hudspeth v. Commissioner*, 509 F2d 1224 (9th Circuit 1975)].

INSTALLMENT OBLIGATION DISPOSITIONS AT DEATH

Income Tax Basis

Generally, upon death of a property owner, the property receives a new income tax basis (the so-called "stepped-up basis"), and the potential gain or loss is eliminated. But on the death of a seller within the term of an installment sale transaction, the installment obligation as an asset of the estate does not receive a new basis. Payments received after death are reported in the same manner, for income tax purposes, as the seller would have done if living. There is, however, a deduction for the estate tax attributable to the obligation. This feature may pose an income tax disadvantage compared with retention of the property until death. The disadvantage is greatest for property that has appreciated substantially in value.

Transfer to the Obligor

Previously unreported gain from an installment sale will be immediately recognized by (become part of) a deceased seller's estate, if the installment obligation is transferred by bequest or inheritance from the decedent to the obligor (purchaser) or is canceled by the seller's executor. For example, suppose a father sold 10 acres of woodland to his only son, John, in 1990 for \$96,000 using an installment sale. After receiving the first two payments under the contract, the father died with the contract passing to John by inheritance. All unreported gain in the installment obligation would be taxable to the father's estate.

In order to avoid this result, installment obligations could be bequeathed to family members other than the obligor. This would mean that family members would own each other's installment obligations but not their own and that payments

would have to continue to be made. Another possible method of avoiding acceleration of income to the estate as a result of a disposition of an installment obligation to the obligor might be to provide that the obligation be transmitted to an irrevocable trust in which the obligor is a beneficiary. The obligor would have to continue to make payments that would constitute income to the trust, but the estate could argue that no taxable obligation had occurred because the trust has to be treated as a separate taxpayer.

INSTALLMENT SALES BY THE ESTATE

A different rule applies if the estate is the seller under an installment obligation. In that case, distribution of the obligation to the heirs causes immediate taxation of the gain in the obligation under all circumstances. For some assets with a new income tax basis received at death, the amount of gain may be little or none. But if the sale involves timber property that had been valued under special use valuation (see chapter 13), the amount of gain could be substantial. The new basis at death would only be up to the value set for Federal estate tax purposes--in this case, special use value--and not up to fair market value.