

Chapter 35

INSTALLMENT SALES AND SCINS

WHAT IS IT?

The installment sale is a device for spreading out the taxable gain and thereby deferring the income tax on gain from the sale of property. The key ingredient in an installment sale is that at least one payment will be received by the seller after the taxable year in which the sale occurs.

The self-cancelling installment note, or SCIN, is a variation of the installment sale, a hybrid between an installment sale and a private annuity (see Chapter 36). It is not a statutory device and its taxation is covered by interpretation of statutes by the courts, the IRS and taxpayers. When it is used, the note contains a provision under which the balance of any payments due at the date of death are automatically canceled, with language such as the following:

“Unless sooner paid, all sums due hereunder, whether principal or interest, shall be deemed canceled and extinguished as though paid upon the death of (Seller).”

It must be provided, however, that the term of the SCIN will be less than the life expectancy (actual) of the seller; otherwise, it will be taxed as a private annuity.

The uses of an installment sale or SCIN for estate planning purposes, as explained in this chapter, are based on the federal estate tax as in effect for years beginning before January 1, 2010, or after December 31, 2010. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA 2001) increases the exemption equivalent of the estate tax unified credit each year over a 9-year period, then repeals the estate tax for one year in 2010. For years beginning after December 31, 2010, the provisions of EGTRRA 2001 sunset (or expire), and absent other action by Congress, the estate tax unified credit would presumably revert to \$1,000,000.

WHEN IS THE USE OF SUCH A DEVICE INDICATED?

1. An installment sale is indicated when a taxpayer wants to sell property to another individual who may not have enough capital to purchase the property outright. The installment sale provides a way, for example, for employees with minimal capital to buy out a business owner who, in return for allowing a long-term payout, may receive a higher price for his business. This device is often used to create a market for a business where none previously existed.
2. An installment sale is indicated where an individual in a high income tax bracket holds substantially appreciated real estate or securities (other than marketable securities). In certain cases, all or a portion of the tax on a sale of such property can be spread over the period of installments.¹

One of the big advantages of the installment sale with respect to certain property is that the taxable gain is prorated over the payment period. This means that the seller will pay the tax due only as actual payments from the sale are received. The seller may be able to shift most of the profit from a high income (high tax) year to a year or years in which he or she is in a lower bracket.
3. The installment sale permits more flexibility than the private annuity, an alternative. The agreement can be made to begin or end whenever the parties involved desire. This eliminates the need to follow a rigid schedule of payments such as is found in a private annuity.
4. An installment sale can be an effective estate freezing device where the sale is between family members and involves rapidly appreciating closely held stock, real estate, or other assets. Used in this manner, the installment sale may serve to freeze the size of an estate subsequent to the sale and thus stabilize the value of the seller's estate for federal estate tax purposes and shift future appreciation to a younger generation. An installment sale to a grandchild at full fair market value, for example, will avoid the generation-skipping transfer tax.
5. A SCIN is appropriate in instances where the seller desires to retain a payment stream that will not

continue beyond his or her death and may end at an earlier date. Unlike a private annuity, the SCIN allows the buyer to depreciate assets based on the purchase price paid and to deduct the portion of payments attributable to interest expense.

6. ASCIN is appropriate where the tax benefits attributable to excluding the unpaid principal from a taxable estate exceed the income tax cost that results from the buyer paying a premium for the cancellation at death feature.

WHAT ARE THE REQUIREMENTS?

1. A seller of property can defer as much or as little as desired using an installment sale and payments can be set to fit the seller's business or financial needs. The amount of payment received in the year of the sale is irrelevant. A sale for \$1,000,000 can qualify even if \$500,000 is paid in the year of the sale and the remaining \$500,000 (plus interest on the unpaid balance) is paid over the next five years.

Conversely, since a SCIN is a hybrid between an installment sale and private annuity, its requirements are still being determined. The IRS has stated its position as to when it will accept a SCIN.² Of importance is the requirement that the term of a SCIN not extend beyond the seller's life expectancy.

2. No payment has to be made in the year of the sale. The only requirement is that at least one payment must be made in a taxable year *after* the year of sale.³ This means the owner of property can contract to have payments made at the time when it is most advantageous or least disadvantageous. For example, the parties could agree that the entire purchase price for payment of a \$1,000,000 parcel of land will be paid five years after the sale.
3. No minimum sale price is required.
4. Installment sale treatment is automatic unless the taxpayer elects *not* to have installment treatment apply.⁴ A SCIN is treated as a private annuity if the term extends beyond the seller's life expectancy.
5. A sale can be made on an installment basis even though the selling price is contingent.⁵
6. Installment reporting is not available for sales of marketable securities.⁶

HOW IT IS DONE – AN EXAMPLE

An individual would like to sell property she now owns. Her accountant has explained that a high tax on the inherent gain in the property could consume a substantial portion of her profit. If she receives all of the sale proceeds in the year of sale, the result is that her entire profit will be taxed in one year. So she would like to find a way to reduce or minimize the impact of taxes, or defer those taxes.

The installment sale is a possible solution to that problem. By taking advantage of the installment sale provisions of the Internal Revenue Code, she may be able to save a great deal of money.⁷ Under an installment sale, the title to the property passes immediately from the seller to the buyer. But the distinguishing feature of an installment sale is that the seller does *not* receive a lump sum payment outright. Instead, the seller typically receives the sale price in installments spread out over two or more tax years (although a lump sum payment in a later year will qualify for installment reporting).

Example: If Mrs. Murphey sold land that cost her \$50,000 and received \$100,000, she would have a \$50,000 gain reportable all in the year of the sale. But if she sells it for \$100,000 and agrees to accept \$10,000 a year for 10 years (plus appropriate interest on the unpaid balance), she will not have to report the \$50,000 gain in the year of the sale. Instead, since her ratio of gross profit (\$50,000) to contract price (\$100,000) is 50%, she will report \$5,000, 50% of each \$10,000 payment she receives, as capital gain. (Interest has been ignored here for simplicity.)

To compute the payment, use a hand held financial calculator or computer program. You need to tell the calculator or computer the:

- (1) Interest rate (for semiannual divide annual rate by two);
- (2) Number of periods (for semiannual multiply years by two); and
- (3) Amount to be repaid.

The result will be the annual (or other payment period) payment necessary. For example, to compute the semiannual payment where property worth \$100,000 is sold over a 10-year period and the interest rate is 9%, input 4.5 (the annual interest rate divided by two) and

press the *i* (interest) button; input 20 (two payments a year for 10 years) and press the *N* (number of periods) button; and input the present value of the loan, \$100,000, and press the *PV* (present value) button. Then press *PMT* to compute the \$7,687.61 outlay.

The rule used to compute the annual gain above is:

Income is realized on each annual payment received in the same proportion that the gross profit (selling price less seller's adjusted basis) bears to the total contract price (amount to be received by the seller).

If the sale results in a loss, the installment method may not be used. The loss deduction must be taken in the tax year of the sale.⁸

More technically, for income tax purposes, the installments must be broken into three parts: (1) a return of basis; (2) the gain portion; and (3) interest income. The taxpayer must report that part of the payment that represents the gain on the sale and the interest income.

Interest is segregated from principal payments and taxed as ordinary income. The profit percentage (basically the gain, or difference between the sale price and adjusted basis, expressed as a percentage of the total contract price, exclusive of interest) is applied to each installment payment of principal in order to determine the amount of each payment that is gain. The balance is considered a tax-free return of the seller's basis. (See Figure 35.1.)

What if the agreement does not specify an interest rate or the stated interest rate is inadequate? This often occurs in intra-family transactions. These types of sales

will be taxed according to what is known as the "unstated interest" rule. Under this rule, the Internal Revenue Service is allowed to "impute" interest (a legal fiction in which all the parties to the transaction are treated as if interest was paid at a statutory rate, compounded semiannually) unless the parties have agreed to at least a "safe harbor" rate of return on the unpaid balance.⁹ In other words, a portion of the deferred payments will be treated as interest to both the buyer and the seller. For all tax purposes, from the buyer's perspective that part of a payment that is considered interest does not increase the basis of the property received; however, the buyer may be allowed an interest deduction. For additional details, see Chapter 37.

For SCINs, a premium is required to reflect the possibility that the seller will die during the term of the SCIN. Because the unpaid principal is forgiven upon an early death, the present value of expected payments will be less than the purchase price unless an adjustment is made. The adjustment is made by increasing the payments under the SCIN so that actuarially the present value of payments equals the purchase price.

There may be some flexibility to increase SCIN payments by either raising the interest rate or principal due on the rate. If the interest rate is increased, the buyer may take greater interest expense deductions. If the principal is increased, the buyer will have a higher base for taking depreciation deductions.

The following rules should be considered: Interest will not be deductible if it is considered "personal." Generally, this means the interest deduction will be denied unless the debt was properly allocable to:

Figure 35.1

TAXATION OF SELLER UNDER INSTALLMENT SALE		
	A. Recovery of basis (cost element)	Tax free
	B. Gain element	Capital gain or ordinary income
	C. Interest income	Ordinary income
Computing Tax Free, Gain, and Interest Elements of an Installment Payment		
STEP 1	Segregate interest from payment principal	
STEP 2	Compute portion of principal payment which is gain	$\frac{\text{Total gain}}{\text{Sales price}} \times \text{principal payment}$
STEP 3	Compute portion of principal payment which is a return of capital	Principal payment - gain (Step 2)

- (1) Investment purposes (if the property or stock to be purchased is investment property, the interest deduction will generally be allowed, but only to the extent of the buyer's investment income);
- (2) The conduct of a trade or business (other than the trade or business of performing services as an employee), in which case the interest would be deductible without limit;
- (3) Part of the computation of income or loss from a passive investment activity;
- (4) Estate or generation-skipping transfer taxes in installments under Internal Revenue Code Sections 6166 or 6161 (there is no limit on the amount of interest deduction in this case, but no deductions are allowed for interest paid in installments under Section 6166 for decedents dying after 1997); or
- (5) A debt secured by property that at the time the interest is paid or accrued is a qualified residence (this is called "qualified residence interest" and is generally deductible only if the residence in question is the taxpayer's principal residence or a second residence). This deduction is limited to interest on a maximum of \$1,000,000 of "acquisition indebtedness" and up to \$100,000 of "home equity indebtedness."

Imputed interest is considered only for purposes of the income tax; it does not directly affect the terms of the sale. The imputed interest rules are extremely difficult and will not be discussed at length. The following rules of thumb should be helpful in planning the interest rates that should be built into an installment sale:

- (1) There will be no imputed interest problem unless the installment sale contract (a) does not state *any* interest on the unpaid balance, or (b) the specified interest rate is less than the "applicable federal rate" (AFR), except as noted below.
- (2) Certain sales of family land to family members require only that the interest rate assumed by the parties be 6%, compounded semiannually, or greater if the transaction is for \$500,000 or less. The AFR is applied to amounts over \$500,000.
- (3) If the selling price is under \$4,630,300 (in 2006), interest will be imputed at the lower of (a) 9%, compounded semiannually, or (b) the applicable federal rate. The selling price under which either rate applies is adjusted annually for inflation.¹⁰

WHAT ARE THE TAX IMPLICATIONS OF THE INSTALLMENT SALE?

1. Many of the income tax ramifications have been mentioned above. Note also that depreciation recapture as well as any investment tax credit recapture is reportable in full in the year of the sale, even if no proceeds from the sale are received in that year.

Stock or securities that are traded on an established securities market do not qualify for installment treatment; all payments to be received are treated as received in the year of disposition.

In addition, installment treatment is generally not allowed for sales of depreciable property to a controlled entity, such as a more than 50% owned partnership or corporation, or trust benefiting the seller or the seller's spouse. All payments to be received are treated as received in the year of disposition.

2. An installment sale will remove the property in question from the transferor-seller's estate, but the present value of any installments due at the seller's death must be included.¹¹ For instance, if at the date the seller died 10 annual payments remained on an installment sale, and each payment (made at the end of the year) to the estate or its heirs were \$12,000, using a 5.0% AFR assumption, \$92,660, the present value of the 10-year stream of payments remaining would be includable in the seller's gross estate (\$12,000 × 7.7217 term certain annuity factor for 5% and 10 years from Appendix B). However, the installment sale is still a valuable estate planning tool since it removes the future appreciation on the property from the transferor-seller's estate without any gift tax implications. For instance, at a 10% growth rate, property worth \$500,000 when sold in exchange for 10 annual payments would be worth \$1,296,871 when the payout was complete.

Additionally, a great deal of the cash proceeds of the sale may be removed from the seller's estate, gift tax free, by maximizing the use of the annual exclusion. After receiving payments, the seller could then give back – at his or her whim – all or a portion of the amounts paid.

3. For federal gift tax purposes, there is a split of authority in the courts as to whether the interest rate charged on the family installment sale must be equal to the prevailing market rate, the applicable federal rate, the special rates applicable to sales of

farm land under \$500,000, or the 9% rate specified in the case of sales under \$4,630,300 (in 2006) that are charged for *income* tax purposes. (See the related discussion in Chapter 37.) The Tax Court has held in two separate cases that if a rate lower than the prevailing market rate is used, there will be a taxable gift measured by the difference between the fair market value of the property sold and the discounted present value of the installment note that is based on the lower interest rate used for sales of land (6%).¹² However, in one of these cases on appeal, the Court of Appeals for the Seventh Circuit reversed the Tax Court decision and held that the use of rates specified for income tax purposes would also control for gift tax purposes.¹³ Conversely, in the other case on appeal, the Court of Appeals for the Eighth Circuit sustained the Tax Court's position on the issue and held that the income tax rate does not control for gift tax purposes.¹⁴ The Supreme Court has refused to review the Eighth Circuit Court's decision.

It should be noted that the sales in both of the above cases arose before the adoption of applicable federal rates of interest, and it would seem that these federal rates should eliminate the gift tax problem. However, the law is unclear on what would happen if the federal rates were lower than prevailing market rates.

4. If the seller should die, the remaining payments are "income in respect of a decedent." (See the Questions and Answers, below.) As a result, the estate, or other testamentary beneficiary of the installments due would report the payments in the same way that the decedent would have reported them had he lived.¹⁵ In other words, the allocation of the payments (return of basis, gain, or interest) is not affected by reporting on the installment basis.

There is no step-up in basis at death; however, the testamentary beneficiary of the installments would be entitled to an offsetting income tax deduction to the extent of the estate tax attributable to the installment sale balance that was taxed in the estate.¹⁶

5. It is important to note the effect of an installment sale on the property's basis for purposes of computing gains and losses and in order to compute the depreciation deduction available to the transferee-buyer. In the case of an installment sale, the transferee-buyer has a new income tax basis for the property, its fair market value at the date of the sale (i.e., the purchase price).¹⁷ The transferee's basis is stepped-up, not carried over, for depreciation purposes.

One result of this stepped-up basis is that (subject to the "second disposition" rules discussed below) a lower bracket family member purchasing the property can sell the property transferred and reinvest the sale proceeds in more liquid or higher yielding assets and probably pay much less in tax on the sale than the transferor-seller would otherwise have had to pay.

An increased basis is of particular advantage in the case of high value, low basis property such as highly appreciated real estate. For example, if the transferor-seller bought undeveloped, non-income-producing land 10 years ago for \$10,000 and it is now worth \$100,000, he could sell it to his son for its \$100,000 fair market value. After holding the land for at least two years (see below), the son could then sell it and purchase mutual funds or other income-producing securities with the proceeds of the sale. If the son received \$105,000 for the land, his gain would be only the difference between his \$100,000 cost and the amount realized on the sale, \$105,000 (i.e., his total gain would be \$5,000). He does not have to pay tax on the \$90,000 gain his father would have been subject to had he sold the land. The advantage is compounded if the son is in a lower tax bracket than his father.

The overall tax savings is even more dramatic if the father is in a relatively high income tax bracket at the time of the sale, but is about to retire. Future payments from son to father would spread out the profit and defer taxes. Since the father may be in a lower tax bracket after retirement, less of his profits would be lost in the form of taxes.

6. Special rules apply to installment sales to related parties. For example, certain "second dispositions" (resales) by a related party purchaser trigger recognition of gain *by the initial seller*. In essence, this rule, stated in more detail below, provides that the original seller's gain on an installment sale will be accelerated if a trustee or other purchaser related to the seller resells the asset within two years of the installment sale.
7. Generally, interest paid by the purchaser on the unpaid balance will be deductible in full only if the debt is properly allocable to investment purposes (and then only to the extent of investment income) or to business purposes.

Special Rules for Disposition of Property Between Related Parties

Technically, there are three "related party" rules: one applicable to second dispositions of installment

sale property by a related purchaser; a second that applies only to installment sales of depreciable property between “closely related” entities; and a third applicable to forgiveness or cancellation of installment debt between related parties. The term “related party” for purposes of these rules, includes brothers and sisters, spouses, ancestors, and lineal descendants, as well as many other related entities.¹⁸

“*Second disposition*” rule: The rule for “second dispositions” of installment sale property is as follows: If a related party (defined below) disposes of the property he has purchased in an installment sale (in other words if a “second disposition” occurs) before the initial seller (the person who made the “first disposition”) has received all the payments he is due under the installment sale, then the amount realized on the second disposition is treated as received – at the time of the second disposition – by the initial seller.¹⁹ For instance, if a mother sells appreciated land to her daughter, and the daughter immediately resells the land, the mother must report the gain.

Fortunately, the reportable gain is limited. Gain, based on her profit percentage, is reportable by the mother only to the extent the daughter receives more in the second disposition than she has already paid her mother. So the initial seller’s gain would be accelerated only to the extent additional cash or other property flows into the related group because of the “second disposition.”

Although there are no regulations that illustrate mathematically how the second disposition rules apply, it should be as follows:

1. When the related person disposes of the property (the second disposition) before the person making the first disposition receives all payments due from that sale, the first seller is treated as having received the amount actually received by the second (related) seller at the time of the second disposition. For example, assume Herb Cheezman bought land for \$500,000 and sold it to his son Stephen for \$600,000. Assume also that Stephen agreed to pay \$60,000 a year for 10 years. (For simplicity, interest is ignored.) In the second year Stephen sells the land to a third party for \$1,000,000. Herb is treated as having received \$1,000,000 in the second year.
2. There is a limit, however, on the amount Herb must report.

The person making the first disposition (Herb) reports only the amount by which the *lesser* of:

- (A) (1) the total amount realized with respect to the second disposition by the close of the tax year, (in this example it is \$1,000,000)
or
(2) the total contract price for the first disposition (in our example, \$600,000) \$600,000
exceeds the total of
- (B) (1) the sum of payments actually received with respect to the first disposition (Herb received \$60,000 x 2 years, or \$120,000)
plus
(2) the aggregate sum treated (under the related party — second disposition rules) as received with respect to the first disposition for prior taxable years (here \$0) 120,000
So, in this example, Herb would report gain of \$480,000

Of course, Stephen would be required to recognize his gain on the sale (i.e., the second disposition)—\$1,000,000 (amount realized) minus \$600,000 (Stephen’s cost basis), or \$400,000.

3. Where a second disposition results in recognition of gain to the first seller (Herb), subsequent payments actually received by the first seller from the related purchaser (Stephen) will be tax free until they have equaled the amount realized as a result of the second disposition.

There are limited exceptions to the “second disposition” rule. If the second disposition occurs more than two years after the date of the first sale, the rule will not apply (unless the sale was of stock or securities).²⁰ So, if Stephen waited two years and one month before he sold the land, Herb would not realize any gain as a result of Stephen’s disposition. Stephen, of course, would have to report gain based on the difference between the amount he realizes on the sale (assume \$1,000,000) and his basis (cost) of \$600,000. Note that there is *no* 2-year exception for sales of stock or securities. Thus, if Herb sold his son Stephen *stock* instead of land, the time period for the “second disposition” rule is unlimited, and Herb will recognize gain on any subsequent disposition by Stephen, to the extent that Herb has not received all payments due on the sale. (Installment reporting is unavailable for sales of publicly traded stock or securities occurring after 1986.) This rule also will not apply if the second disposition results from the death of either party or from an involuntary conversion.

Rule for sales of depreciable property: A sale of depreciable property between related entities may not be reported on the installment method, unless it can

be shown that avoidance of income tax was not a principal purpose.²¹ This rule, unlike the other two “related party” rules, applies only to related entities, such as a corporation and an individual who owns more than 50% of its outstanding stock.

In addition to this rule, there is a special rule for *all* installment sales of depreciable property, regardless of whether the buyer and seller are related. Generally, that rule (described below) requires recapture of certain depreciation deductions claimed by the seller.

Rule for cancellation of debt: If an installment sale between related parties is canceled or payment is forgiven, the *seller* must recognize gain to the extent that the fair market value on the date of cancellation (or the face amount, if less) exceeds the seller’s basis in the obligation.²² “Related party” has the same meaning for purposes of this rule as for the “second disposition” rule.

Special Depreciable Property Rule

The installment sale reporting method generally does not apply to any portion of the sales price that is attributable to the prior depreciation deductions on personal property, such as equipment, or the prior depreciation deductions on certain commercial real property that was placed in service after 1981, but before 1986, and depreciated using an accelerated method of depreciation (faster than the straight line method). In addition, the installment sale reporting method does not apply to the portion of the prior depreciation deductions on residential and certain commercial real property that are in excess of the amount that would have been deducted if the taxpayer had used the hypothetical straight-line method.

These amounts, which are not subject to the installment sale reporting method because of the depreciation deductions (so-called depreciation recapture), must be reported by the seller in the year of the sale up to the amount of the seller’s gain – even if any other gain is reported on the installment basis as payments are received.²³

Since depreciation recapture must be reported in the year the property is sold, that amount can be added to the seller’s basis. It therefore has the effect of reducing the reportable income that must be realized each year.

For instance, Charles Plotnick sells tangible personal property to Nick Martin for \$70,000, to be paid in three installments. Interest is paid on the unpaid balance at current rates. Assume this is 9%. Also assume that the property originally cost \$90,000, but has an adjusted basis of \$50,000 at the time of the sale because Charles has taken depreciation deductions totaling \$40,000.

Charles must “recapture” his depreciation up to the amount of his gain (the \$20,000 difference between the sale price of \$70,000 and his adjusted basis of \$50,000). Since he must include the \$20,000 of recaptured deductions as income in the year of the sale, he can increase his basis by \$20,000 (from \$50,000 to \$70,000). Since he now has a 100% basis, he will realize no gain as payments are received.

Payments, exclusive of interest, should be \$23,333, which is tax-free as a recovery of basis. But what if Charles sold the property for \$110,000? The gain would be \$60,000 (the \$110,000 amount realized minus his adjusted basis of \$50,000). The entire \$40,000 he previously deducted as depreciation must now be recaptured. Since he must report \$40,000, he can add that amount to his \$50,000 basis. Thus, it now totals \$90,000. Each payment, exclusive of interest, is \$36,667 ($\$110,000 \div 3$). Of this, \$30,000 will be a tax-free recovery of basis, and the \$6,667 balance will be gain.

Note, however, that installment treatment is not allowed for sales of depreciable property to a controlled entity, such as a more than 50% owned partnership or corporation, or a trust benefiting the seller or the seller’s spouse. All payments to be received are treated as received in the year of disposition.

WHAT ARE THE TAX IMPLICATIONS OF THE SCIN?

All of the tax rules applicable to the installment sale apply to the self-cancelling installment note. However, there are additional factors to consider.

The Tax Court has held that in the case of installment sales from decedent to his children, with a provision that in the event decedent died before payments were completed, the balance would be canceled, the installment sale results in realization of taxable gain reported in the decedent’s final return.²⁴ This decision was based on Code section 453B, which provides that where an installment note is canceled or becomes unenforceable,

this is treated as a taxable disposition of the note. On appeal, the Court of Appeals for the Eighth Circuit reversed the Tax Court decision, but only by holding that the gain would be fully taxable to the decedent's estate as income in respect of a decedent, not as income on the decedent's final income tax return.²⁵

In GCM 39503, the IRS set forth the circumstances under which a SCIN will be treated as an installment note and under which circumstances it will have income tax consequences as if it were a private annuity.

Note that for gift tax purposes, the actual value of the SCIN received by the seller is not equal to its face value, because the risk of death is a factor that clearly affects the value of the note. If this is not considered, the transaction will be treated as a bargain sale, with gift tax consequences to the seller. If the selling price is increased to include the consideration of the risk of death, and the seller lives to receive all payments, the seller will have to report gain in excess of the actual gain that would have been realized had the property been sold at fair market value. An alternative is to use a higher interest rate, but this will result in a larger amount of ordinary income compared to an increase in the principal amount.²⁶

What are the estate tax consequences of the SCIN? The Tax Court has held that since the balance of the note is canceled at the death of the seller, there is nothing to include in his or her estate.²⁷ The IRS agrees, at least in part.

HOW LIFE INSURANCE CAN ENHANCE THIS PLANNING TOOL

Where an individual (or business) transfers property to someone else in return for installment payments, the seller will often purchase insurance on the life (or lives) of the transferee(s) to protect against the potential cessation of payments at the death of the transferee(s). The seller should consider owning, paying premiums on, and being the beneficiary of the policy (the agreed-upon amount of payments made by the purchaser of the property could be increased to provide enough cash to make premium payments).

After the installment sale agreement is signed, the transferee-buyer receives title to the property. This means that the asset itself, as well as any appreciation from the date of the transfer, will be included in the transferee's estate. To provide the liquidity necessary to pay taxes and other death expenses, life insurance is often pur-

chased on the transferee's life by the transferee's spouse, adult children, or on behalf of the transferee's spouse and children by the trustee of an irrevocable trust. The spouse, adult child, or trustee would be the owner, premium payer, and beneficiary of the policy proceeds. In intrafamily transfers, the transferor-seller often will make a gift to the policyholder of enough cash to pay premiums on the insured's life.

A third use of life insurance for improving the benefits of an installment sale is to assure that the transferee's family has enough cash at his or her death to make the promised installment payments. (Since the property will be in the transferee's estate after the sale, its inclusion could generate substantial estate and inheritance tax problems. This, in turn, creates a need for cash to pay increased death costs and, thus, drains the estate of cash to make installment payments.)

However, if the transferee's spouse purchases the appropriate amount of insurance on his life, there will be no need to sell or liquidate the transferred asset (perhaps closely held corporate stock) in order to make the agreed upon installment payments. The insurance proceeds can be used to pay death costs, make installment payments, or both.

IMPLICATIONS AND ISSUES IN COMMUNITY PROPERTY STATES

Installment sales by married individuals in community property states often involve real property. In such situations, it is important to ascertain whether the interest in real property is community property. Both spouses should join in any conveyance of community real property. If one spouse does not join in the conveyance of community real property, he or she may be able to void the sale for a specified period (e.g., one year from the date of recording of the deed in California). This statute of limitations applies only to land standing in the name of the transferor spouse alone. If the land stands in the name of both spouses, an attempt by either spouse to transfer complete title would be void with respect to the interest of the other spouse. Certain sales made to parties, in good faith, who are not aware of the marriage relationship may be incontestable, but such controversies should be avoided.

A purchaser of personal property should also ascertain whether any community property rights are involved. California does not require the written consent of each spouse in connection with the sale of community personal property if the property is sold for "valuable

consideration.” However, as an exception, neither spouse can sell, convey, or encumber the furniture, furnishings, or fittings of the home or wearing apparel of the other spouse or minor children without the written consent of the other spouse.

Problems could arise as a result of cases regarding joint property rights of non-marital partners. Some courts have found implied agreements between non-married individuals to treat their property similarly to community property. Caution should be exercised if property is purchased from an individual involved in such a relationship. It may be advisable to ask the partner who may have a claim to convey title to any interest he or she may have in the property.

Another possibility to consider is the separate sale of each spouse’s interest. One spouse could sell his or her interest outright and recognize all of his or her capital gain immediately, while the other spouse could sell his or her interest on the installment method and spread out his or her capital gain. This can reduce capital gain taxes while effectively allowing a greater amount of the sale price to be received in the year of the sale.

If undivided interests are sold at a discount, the amount of capital gains will be less, thereby creating estate tax savings and lower installment payments.

QUESTIONS AND ANSWERS

Question – How can the related party rules be avoided?

Answer – For property other than marketable securities, the related purchaser could hold the property for at least a 2-year period after the sale (to the extent that the special depreciable property rule does not apply). The installment obligation could be structured so that no payments need to be made until after the 2-year holding period has lapsed. If the related party was going to sell the property to raise cash to make installment payments, as an alternative the related party could use the property as collateral for a loan to provide the funds needed to make installment payments. (Note, however, that the loan must be bona fide, and the debtor must continue to bear the economic risk of loss.)

A private annuity could be used instead of an installment sale to avoid all three related party rules. Since the installment sale rules do not deal with private annuity arrangements, the transferee should be free to dispose of the transferred property

at any time without accelerating the recognition of gain to the transferor.

In any installment sale to a related party, the risk of illiquidity of the initial seller in the event of a second disposition by the new owner should be considered. How can this potential problem be overcome? Perhaps the seller might insist on an acceleration clause. This would give the seller the right to demand additional cash payments if the property subject to the installment sale is disposed of before the 2-year waiting period has been met.

It probably would not be advisable to impose formal restrictions on the related purchaser’s ability to dispose of the property. Likewise, it probably is not wise to give the seller a legal right to insist that the purchaser must lend him funds to pay a tax imposed on a second disposition. Such contractual restrictions or requirements could be viewed by the IRS as evidence that the entire transaction lacked economic substance.

Question – What type of security can the seller of property under an installment sale require without being taxed on his entire gain in the year of the sale?

Answer – A third party can guarantee payment in the event the buyer defaults. For example, a standby letter of credit that is used as security for a deferred payment sale will not be treated as a payment received on the installment obligation.²⁸

But third party notes or other third party obligations that are transferable or marketable prior to default by the installment buyer will be treated as payments to the seller (and therefore taxable in the year received).²⁹

Typically, the IRS and the courts will deem funds placed in an escrow account to secure the interest of the seller to be constructively received – and, therefore, currently taxable in the year of the sale. However, this result is not certain. No presumption of tax avoidance arises merely because the seller requested an installment payout or merely because the buyer was at all times willing to pay the entire purchase price in a lump sum.

The seller is more likely to be successful in avoiding current taxation of escrowed funds if (1) the arrangement serves a legitimate business purpose, and (2) the seller continues to look to the contractual obligation of the buyer for payment. An example

would be where the escrow arrangement was negotiated in a manner that provided that payments from the escrow account were contingent on the seller's continued adherence to his agreement not to compete. This type of agreement would probably not result in constructive receipt by the seller even if he could control the investment of the money in the escrow account.

Question – What are the income and estate tax implications when the holder of an installment obligation dies?

Answer – The right to receive payments under the obligation is treated as income in respect of a decedent. Thus, payments on the installment obligation are taxable income to the person or entity that receives those payments as they are received. Payments are taxed in the same manner as they would have been taxed had the seller lived and received payment himself.

For estate tax purposes, the present value of the installment obligation is also includable in the decedent's gross estate. But to reduce the harshness of double taxation, a deduction from income is allowed to the recipient based on the federal estate taxes paid by the decedent's estate attributable to the inclusion of the installment obligation. This is called the Section 691 (income in respect of a decedent) deduction.

Question – Is there a problem in arranging an installment sale of property with an existing mortgage on it?

Answer – Yes. Where property subject to an existing mortgage is sold and the purchaser assumes or takes the property subject to that mortgage, any debt in excess of the seller's tax basis (cost) will be considered a payment received by the seller in the year of the sale. Any mortgage encumbering the property will be treated as assumed or taken subject to, even though title to the property does not pass in the year of sale and even though the seller remains responsible for payment of the mortgage (as in a "wrap-around" mortgage).³⁰

Question – Does the "second disposition" rule mean there are no advantages to a transfer of property (which is not within the special depreciable property rule) from an individual to an irrevocable trust established for his family in return for installment payments or SCIN payments?

Answer – Many advantages still exist, including the following:

- (1) Taxation on the gain can be spread over a larger number of years (assuming the trust does not dispose of the property within two years, and assuming the trust does not benefit the seller or the seller's spouse if the property is depreciable to the trust). This could lower the applicable total rate.
- (2) The family of the seller is more secure from the claims of his creditors.
- (3) No gift tax is incurred on the transfer if the property is sold to the trust at its fair market value.
- (4) The trust may have little or no gain on the resale of the asset since it takes as its basis the full purchase price it agreed to pay. (Of course, the property may appreciate or decline in value during the two years it must be held in order to avoid accelerating the initial seller's gain.) The amount of gain to the buyer will be reduced if a SCIN having a premium on principal is used.
- (5) None of the assets of the trust, or income, will be includable in the original owner's estate if the trust is irrevocable and the seller maintains no control. (The present value of future payments remaining on the note would, however, be includable if he died within the installment period. This, in turn, could cause a serious lack of liquidity. Conversely, the payments due on a SCIN are canceled at death and excluded from the seller's estate, but liquidity is needed for any income tax due at death.)

To obtain this favorable treatment, it is important that:

- (1) The trustee be completely independent, and the grantor maintain no control over the trustee's actions;
- (2) There be no prearrangement between the parties requiring the trustee to resell the property;
- (3) The original owner not have a stake in the resale by the trust (i.e., the amount he receives cannot be dependent on the amount the trustee receives);

- (4) There be a motive—other than tax savings—for the arrangement; and
- (5) The “2-year holding rule” be met.

Question – Must there be any down payment in the year of sale to qualify for the installment method of reporting?

Answer – No. There is no requirement that there be any payment in the year of sale. The only requirement of this type is that at least one payment be made in a taxable year *after* the year in which the property was sold. However, some practitioners believe that if a trust created by the seller or a related party is the buyer, the buyer should have additional assets to make the payments, or a guaranty of the note should be given, so as to avoid possible inclusion of the sold asset in the seller’s estate.

Question – Will a bequest of an installment obligation to the obligor avoid tax recognition of the untaxed gain by the seller?

Answer – The installment obligation rules cannot be circumvented by canceling the obligation during the seller’s lifetime. Likewise, when an installment seller dies holding an installment obligation, the gain is not forgiven. Instead, gain is reportable by the seller’s estate—or the recipient of the obligation—as payments are made. The amount of gain and the character of income realized are the same as the deceased seller would have reported had he or she lived. (Note that death itself does not trigger an acceleration of gain; tax is due only if payments are actually or constructively received or if the obligation is sold.)

Under prior law, it had been argued that if an installment obligation was bequeathed to the purchaser of the property, the interests of the obligor and the obligee “merged.” Under this theory, there would be no gain realized because the estate would never realize the unpaid balance.

Current tax law accelerates the unrealized gain when the seller makes a bequest of the obligation to the buyer or his estate cancels the debt. Gain or loss will be recognized to the extent the fair market value of the obligation exceeds the obligation holder’s basis. (Where the decedent-seller and the purchaser are related, the fair market value of the obligation cannot be less than its face amount.)

If a person forgives an installment obligation in his will, the cancellation is treated as a transfer of

the obligation by the decedent’s estate. The estate will report the accelerated gain. If a trust or some party other than the decedent held the obligation, the cancellation will be treated as a transfer by that person immediately after the decedent’s death.

An installment obligation that becomes unenforceable at the seller’s death is treated as if it were canceled in favor of the obligor.

Question – What is the tax effect where the seller cancels a buyer’s obligation to make installments?

Answer – If a seller cancels a buyer’s installment obligation (or it becomes unenforceable), the cancellation will be treated as a “disposition” of the obligation. This means the seller must report gain (or loss). The gain (or loss) is measured by the difference between the fair market value of the obligation at the time of its disposition and its basis.

Note that if the seller and buyer are considered “related persons,” the fair market value of the obligation will be considered as not less than the face value. For instance, mom sells her summer home in Avalon to her daughter in an installment sale in 2006. Mom’s basis in the home was \$12,000. Her daughter will pay the purchase price, \$60,000, in five equal annual \$12,000 installments. (Interest is ignored for simplicity.) If mom immediately cancels the daughter’s obligation, mom must report gain. Her gain is the difference between the value of what is owed to her, \$60,000, and her \$12,000 basis. She is also liable for any gift tax on the gift.

A solution would seem to be for mom to forgive – at her whim, and on a year-by-year basis – all or a portion of each \$12,000 payment as it is paid. Her daughter should write a check for the full \$12,000 to her. Then, without a prearranged or legally binding plan, mom can write her daughter, son-in-law, and each of her grandchildren, checks of \$12,000 or under, all of which would be gift tax-free (and she could double the amount of each check if her husband joined in on a “split” gift). Mom will recognize gain of \$9,600 each of the five years, rather than \$48,000 in the year of sale.

Question – How is gain computed under the installment sale rules where the sale price is not fixed or determinable?

Answer – Often, the price at which property will change hands depends on some contingency. For example,

Susan Harmon may sell her stock in the SH Corporation, a closely held business, to her son Mark in return for installment payments. But rather than selling at a specific dollar price, the amount may be set as a percentage of the gross profits of the business for each of the next 10 years. The parties may – or may not – put a maximum dollar amount on the selling price.

Installment sale treatment is available even when the actual price cannot be determined with precision. If there is a stated maximum selling price, the seller (in this example Susan) can recover basis by means of a “gross profit ratio.”³¹ This ratio is multiplied by the installment payment (exclusive of interest) to determine the portion of the payment that is gain.

$$\frac{\text{gross profit (realized or to be realized)}}{\text{total contract price (assume this is maximum selling price)}} \times \text{installment payment}$$

(The maximum selling price is defined as the largest price that could be paid assuming all contingencies, formulas, etc., operate in the seller’s favor.) The seller then reports income on a pro rata basis (and recovers his basis over the scheduled payment period in equal annual increments) with respect to each installment payment.

Later, if it is found that the contingency will not be met (and therefore the seller will not actually receive the “maximum” selling price) a recomputation of the seller’s income is allowed. The seller may report reduced income (not only in the adjustment year, but in all subsequent years). If as a result of the recomputation, the seller does not recover his or her entire income tax basis for the property sold, the amount of basis will be deductible as a loss.³²

If the sale price is indefinite and no maximum selling price can be determined – but the obligation is payable over a fixed period of time – the seller’s basis would be recoverable ratably over that fixed period.³³

If neither selling price nor payment period can be ascertained with certainty in advance, the arrangement will be closely scrutinized to determine whether there has been a sale or whether the payments, in economic effect, are merely in the nature of rent or royalty income. If it is determined that there has been a sale, the seller’s basis will be recovered over 15 years commencing with the date of sale. Any basis not recovered in that time may be carried forward to succeeding years until recovered in full.

Generally, if in any year payments received are less than the basis allocated to that year, the excess basis must be reallocated over the balance of the 15-year period. (A period other than 15 years may be used or required where it is shown that a substantial and inappropriate deferral or acceleration of the recovery of the seller’s basis would otherwise result.)³⁴

The effect of the contingency sale price rules allowing installment reporting is that taxpayers have little justification for treating transactions as “open.” (In open transactions, a taxpayer can recover his entire cost before reporting any gain, rather than reporting gain ratably.) This “cost recovery” method is available only in rare and extraordinary cases involving sales for a contingent price where it is impossible to value a purchaser’s obligation to pay a contingent price.

Special rules apply with respect to contingent installment payments for sales of depreciable property to a controlled entity, such as a more than 50% owned partnership or corporation. The rules are:

- (1) The seller’s basis is recovered ratably in annual increments if (a) the installment sale is to a controlled entity, and (b) it is impossible to reasonably ascertain the fair market value.
- (2) All noncontingent payments plus the fair market value of contingent payments must be reported in the year of the sale. For instance, assume Tom Miller sells depreciable property to a corporation he controls for no down payment and 10% of the net profits from the business for the next 10 years. Assume the fair market value of the promise can be reasonably ascertained to be \$200,000. Tom would have to include \$200,000 in income in the year of the sale (\$0 noncontingent payments plus \$200,000 fair market value of contingent payments).
- (3) The purchaser of the property may not increase his basis in the property by any amount before such time as the seller includes the amount in income.³⁵

Question – How soon does a taxpayer have to elect to report payments in installments?

Answer – No election is necessary. Installment sale treatment is automatic for qualifying sales unless

an election is made specifying installment sale treatment is *not* to apply. Although the temporary regulations are not specific as to how such an election is to be made, reporting the entire gain in gross income for the taxable year in which the sale occurs (on or before the due date for filing the tax return – including extensions) will operate as an election that installment sale reporting is not to apply.³⁶ Once a valid election out of the installment method has been made, it may not be revoked except under very limited circumstances. The Service has provided guidance in the form of a revenue ruling concerning when it will grant permission to make a late election out of the installment method.³⁷

Question – When might it be a good idea to forego the installment method of reporting a gain, even though a sale was made on the installment basis?

Answer – If a taxpayer has unrelated losses, he might wish to offset those losses with the gain from the installment sale. He may have unusually low income or high deductions for the year. Thus, he or she would report the full gain in the year of sale even though the sale was an installment sale.

Question – When is interest payable on the unpaid balance of an installment sale deductible by the buyer?

Answer – Interest is deductible only in the period in which that interest is properly allocable. Regardless of how the parties have formed the agreement, the IRS will treat the interest as “constant” (whether the taxpayer is on the cash or accrual method). The Service allocates the interest over the term of the contract. The net effect is that the parties must determine the effective interest on a compound interest basis and use that effective rate to compute the amount of any allowable interest deduction.

This rule limits both the interest deduction and the interest income to the amount of interest that accrues economically. The compounding period used in determining the effective rate of interest will probably be the same as that called for in the parties’ agreement.

Question – When will a taxpayer be subject to the interest surcharge for installment sales in excess of \$150,000?

Answer – There is a special interest surcharge imposed on certain installment obligations in which the sale price exceeds \$150,000 and the aggregate deferred

payments for such sales during the taxable year exceed \$5,000,000. There are three exceptions to the application of the surcharge: (1) property used or produced in the trade or business of farming; (2) timeshares and residential lots; and (3) personal use property.³⁸

CHAPTER ENDNOTES

1. IRC Sec. 453.
2. See Rev. Rul. 86-72, 1 CB 253; GCM 39503 (5-7-86).
3. IRC Sec. 453(b).
4. IRC Sec. 453(d).
5. IRC Sec. 453(j); Treas. Reg. §15A.453-1(c).
6. IRC Sec. 453(k)(2).
7. IRC Sec. 453.
8. Rev. Rul. 70-430, 1970-2 CB 51.
9. IRC Secs. 483, 1274.
10. IRC Sec. 1274A; Rev. Rul. 2003-119, 2003-47 IRB 1094; Rev. Rul. 2002-79, 2002-2 CB 908.
11. IRC Sec. 2033; Treas. Reg. §20.2033-1.
12. *Ballard v. Comm.*, TC Memo 1987-128; *Krabbenhoft v. Comm.*, 94 TC 887 (1990).
13. *Ballard v. Comm.*, 854 F.2d 185 (7th Cir. 1988).
14. *Krabbenhoft v. Comm.*, 939 F.2d 529 (8th Cir. 1991), *cert. denied*, 502 U.S. 1072 (1991).
15. Treas. Reg. §1.691(a)-3.
16. Treas. Reg. §1.691(c)-1.
17. *Ballard*; IRC Sec. 1012.
18. See IRC Secs. 453(f)(1), 318(a), 267(b).
19. IRC Sec. 453(e)(1).
20. IRC Sec. 453(e)(2).
21. IRC Sec. 453(g).
22. IRC Sec. 453B(f).
23. See IRC Sec. 453(i).
24. *Est. of Frane v. Comm.*, 98 TC 341 (1992).
25. *Est. of Frane v. Comm.*, 998 F.2d 567 (8th Cir. 1993).
26. GCM 39503 (5-7-86).
27. *Est. of Moss v. Comm.*, 74 TC 1239 (1980), *acq. in result*, 1981-1 CB 2.
28. Treas. Reg. §15A.453-1(b)(3).
29. Treas. Reg. §15A.453-1(e).
30. Treas. Reg. §15A.453-1(b)(3)(ii).
31. Temp. Treas. Reg. §15A.453-1(c)(2).
32. Treas. Reg. §15A.453-1(c)(2), Example (5).
33. Treas. Reg. §15A.453-1(c)(3).
34. Treas. Reg. §15A.453-1(c)(4).
35. IRC Sec. 453(g)(1).
36. Treas. Reg. §15A.453-1(d)(3).
37. Rev. Rul. 90-46, 1990-1 CB 107.
38. IRC Sec. 453A(b).

