2010
INSTALLMENT SALES

BY

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Form **6252**

Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.

OMB No. 1545-0228

2010

Attachment Sequence No. 79

Name(s) shown on return | Identifying number

1 Description of property ▶

2a Date acquired (mm/dd/yyyy) ▶ ______ **b** Date sold (mm/dd/yyyy) ▶ ______

3 Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4 . . . . ☐ Yes ☐ No

4 Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale . . . . ☐ Yes ☐ No

Part I **Gross Profit and Contract Price.** Complete this part for the year of sale only.

5	Selling price including mortgages and other debts. **Do not** include interest, whether stated or unstated		5
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	
7	Subtract line 6 from line 5	7	
8	Cost or other basis of property sold	8	
9	Depreciation allowed or allowable	9	
10	Adjusted basis. Subtract line 9 from line 8	10	
11	Commissions and other expenses of sale	11	
12	Income recapture from Form 4797, Part III (see instructions)	12	
13	Add lines 10, 11, and 12		13
14	Subtract line 13 from line 5. If zero or less, **do not** complete the rest of this form (see instructions)		14
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain (see instructions). Otherwise, enter -0-		15
16	**Gross profit.** Subtract line 15 from line 14		16
17	Subtract line 13 from line 6. If zero or less, enter -0-		17
18	**Contract price.** Add line 7 and line 17		18

Part II **Installment Sale Income.** Complete this part for the year of sale **and** any year you receive a payment or have certain debts you must treat as a payment on installment obligations.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. For years after the year of sale, see instructions		19
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-		20
21	Payments received during year (see instructions). **Do not** include interest, whether stated or unstated		21
22	Add lines 20 and 21		22
23	Payments received in prior years (see instructions). **Do not** include interest, whether stated or unstated	23	
24	**Installment sale income.** Multiply line 22 by line 19		24
25	Enter the part of line 24 that is ordinary income under the recapture rules (see instructions)		25
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797 (see instructions)		26

Part III **Related Party Installment Sale Income. Do not** complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- **a** ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy) . . . . ▶ ______
- **b** ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- **c** ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- **d** ☐ The second disposition occurred after the death of the original seller or buyer.
- **e** ☐ It can be established to the satisfaction of the Internal Revenue Service that tax avoidance was not a principal purpose for either of the dispositions. If this box is checked, attach an explanation (see instructions).

30	Selling price of property sold by related party (see instructions)	30
31	Enter contract price from line 18 for year of first sale	31
32	Enter the **smaller** of line 30 or line 31	32
33	Total payments received by the end of your 2010 tax year (see instructions)	33
34	Subtract line 33 from line 32. If zero or less, enter -0-	34
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35
36	Enter the part of line 35 that is ordinary income under the recapture rules (see instructions)	36
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797 (see instructions)	37

INSTALLMENT SALES

DEFINITION- "The term installment sale means a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs" (IRC Section 453(b) (1)

INSTALLMENT SALES METHOD IS FOR GAINS ONLY

Relieves taxpayer from paying tax on income not yet received

Includes in gross income only portion of each collection that constitutes taxable income.

Must be the payee or mortgagee.(the person who is to be paid the installment payments.)
(Buyers obligation may be in the form of a deed of trust, note, land sales contract, mortgage or other evidence of buyer's debt to seller)

INSTALLMENT METHOD *MANDATORY* IF APPLICABLE

Can ELECT OUT if done by due date (including extensions) of tax return

Irrevocable election without IRS consent to revoke.

When electing OUT, do not always report the ENTIRE realized gain in year of sale.

Use FMV of obligation.

FMV for CASH basis taxpayer is face value but if ACCRUAL basis, gain RECOGNIZED may NOT be same as REALIZED

IMMATERIAL WHETHER USE CASH OR ACCRUAL METHOD OF ACCOUNTING

<u>INSTALLMENT SALES OF 1231, 1245, 1250 PROPERTY</u>

- Must meet installment sale reporting requirements

- **<u>Recapture of 1245 depreciation, including section 179, taxable in year of sale up to</u>** **<u>amount of gain</u>**. (even if no payments received in year of sale)

> **<u>1250 property</u>**:
> Reminder: 1998 Restructuring and Reform Act and 2003 Tax Act - gains on most property held more than 12 months qualify for a 5%, 15% or 25% capital gains rate. ***<u>Watch 2008 through 2010 for: 0%</u>***.
> The 25% rate applies to long term capital gains attributable to **real estate** depreciation (Unrecaptured Section 1250 Gain)
>
> Property held for more than 5 years & disposed of prior to 5/6/03 is subject to the 8% maximum capital gain rate for taxpayers in the 10% or 15% brackets. Property disposed of after 5/5/03, long term capital gain rates are more favorable.
>
> **<u>Final regulations</u>** on recapture of **<u>1250</u>** gain in **installment sales**- applies to ***<u>payments</u>*** properly taken into account after August 23, 1999. (Not just ***<u>sales</u>*** after enactment date)
> August 23, 1999 - Regs. 1.453-12
>
> If gain is partially 25% gain and partially 15/5% gain, taxpayer must take all of the 25% gain into account ***<u>from successive payments before treating any gain as 15/5% gain.</u>*** (This does not mean that all of the 25% gain must be reported in year of sale -as is the case with 1245 recapture)
>
> Installment payments received on or after 5-7-97 for 1250 property sold before May 7, 1997,
> determine applicable capital gains rate as if payments received before 5-7-97 had been allocated first to 25% gain and then to 15/5% gain,
> but — must calculate remaining amount of 25% gain to report by using the actual amount of 25% gain reported on payments received between May 7, 1998 and August 23, 1999.

- Report EACH item separately on form 4797 to determine recapture amount
  - Complete summary section of part III first TWO lines (not final line)
  - Mark **<u>"INSTALLMENT SALE</u>**" at the **<u>GAIN</u>** line and complete installment sale form

NOT QUALIFIED FOR INSTALLMENT METHOD

★ Sales of personal property BY A DEALER

This also applies to REAL property held for sale to customers in the ordinary course of trade or business

Exceptions to dealer dispositions:

- ✓ Property used or produced in trade or business of farming
- ✓ Residential lots, provide dealer or any related person is not obligated to make improvements to the lot and the dealer elects to pay a special interest charge on the deferred tax.
- ✓ Time share rights to use or own residential real property for not more than 6 weeks per year or a right to use specified campgrounds for recreational purposes.
  (Dealer must elect to pay special interest charge on the deferred tax) Section 453(1)(2)(B)(ii)

★ Sales of INVENTORY items

★ Sale of depreciable property to a related party

★ Stock or securities traded on the established securities market

Must report in year in which the trade date falls.

INSTALLMENT SALES

GROSS PROFIT PERCENTAGE

A percentage of each payment (after subtracting interest) which represents gain from the sale

Percentage always remains the same (UNLESS contract changed/discounted)

Computed by dividing gross profit by contract price

Example: Sale for $2,000 and gross profit of $500. Gross profit percentage is 25%. ($500 divided by $2,000)

GROSS PROFIT

Gain from the sale (sales price reduced by commissions and sale expenses) REDUCED by:

- Ordinary income reportable in year of sale (depreciation recapture)

AND

- Postponed or excluded gain on sale of personal residence.

SELLING PRICE

Entire cost of property to the buyer NOT reduced by selling costs.

Includes

Cash

Fair Market Value of property conveyed to seller

Debt buyer assumes or pays

Notes, mortgages and seller's liabilities

(such as liens, accrued interest and taxes buyer assumes or pays and amount of seller's expenses of sale paid by the buyer.

BASIS

Cost if purchased or constructed

OR Gift, Inherited, or Converted Basis

Increased by improvements

INSTALLMENT SALES

ADJUSTED BASIS

Basis plus improvements less basis adjustments
(Casualty Loss Deductions, Depreciation, ITC)

INSTALLMENT SALE BASIS

Adjusted basis
Plus Selling Expenses
Plus Depreciation Recapture

CONTRACT PRICE

Amount seller will receive
Selling price less mortgage assumed (if not in excess of basis)
NOT reduced by expenses of sale
Includes amounts of mortgages assumed IF IN EXCESS OF BASIS

ADJUSTED BASIS AND GROSS PROFIT PERCENTAGE

1. Enter the selling price for the property...________
2. Enter adjusted basis for the property..________
3. Enter selling expenses...________
4. Enter any depreciation recapture..________
5. Add lines 2, 3, and 4. This is the adjusted basis for the installment sale,.________
6. Subtract line 5 from line 1, If $0 or less, enter -0-.**This is gross profit..**________
   If the amount entered on line 6 is $0, Stop here.
   The installment sale method cannot be used.
7. Enter the contract price for the property...________
8. Divide line 6 by line 7...________
   THIS IS THE GROSS PROFIT PERCENTAGE.

INSTALLMENT SALES

MORTGAGE IN EXCESS OF BASIS

To determine if mortgage assumed is in excess of basis, the selling expenses are added to basis.

MORTGAGE PAID OFF BY BUYER AT TIME OF SALE

If paid off (not assumed), INCLUDED IN CONTRACT PRICE.
Seller actually receives the funds and used them to satisfy the debt.

TRADING PROPERTY FOR LIKE-KIND PROPERTY WITH INSTALLMENT NOTE AS 'BOOT'

- ♦ Installment sale "Contract Price" does NOT include value of the LIKE kind property
- ♦ Gross profit reduced by an gain on trade that is postponed
- ♦ Like kind property received in trade is NOT a payment on the installment note.

INSTALLMENT SALES

PAYMENTS RECEIVED

INCLUDE:

- ✓ Down payment
- ✓ All cash payments, including 3rd party notes
- ✓ Property received (other than indebted evidence)
- ✓ Earnest money, option payments, forfeitable deposits from prior years
- ✓ Depreciation recapture ordinary income
- ✓ Payment of assumed liabilities (in addition to purchase cost) of seller

DO NOT INCLUDE:

Amounts received by seller from disposition to third party of notes given by buyer that are due and payable in later years.

ARE NOT REDUCED BY EXPENSES OF SALE

BUYER'S NOTE

Unless payable ON DEMAND is NOT considered payment on sale
Full face value considered to be received on installments

SELLER'S EXPENSES

If buyer assumes and pays expenses seller has in connection with the selling of the property - considered payment in year of sale.

CAUTION: This means that if buyer pays sellers expenses IN ADDITION to other purchase price, NOT if purchase funds are USED to pay the expenses. See "Closing Statements".

INSTALLMENT SALES

PAYMENTS RECEIVED

MORTGAGE ASSUMED

MORTGAGE LESS THAN BASIS (Installment sale basis)

NOT a payment in year of sale
Contract price is selling price minus assumed mortgage
DIFFERENCE is all you will directly collect from buyer

MORTGAGE IN EXCESS OF BASIS

If buyer assumes a mortgage that is more than seller's INSTALLMENT SALE BASIS, seller has, in effect, received ALL of basis PLUS something in ADDITION.

Portion of mortgage in excess of basis is a payment in year of sale IN ADDITION TO other payments buyer makes.

EXAMPLE OF MORTGAGE LESS THAN BASIS

Property sale with an adjusted basis to seller of	$19,000	
Sale expenses	$1,000	
Buyer assumes existing mortgage of		$15,000
In addition to mortgage, agrees to pay	$10,000	

Of the $10,000, cash down payment of $2,000 plus $2,000 per year (plus interest) for 4 years.

Selling price:
Mortgage assumed ($15,000) plus cash ($10,000) = $25,000

Contract price:
Selling price ($25,000) less mortgage assumed ($15,000)= $10,000

Gross profit:
Sale price ($25,000) less installment sale basis ($20,000) = $5,000

Gross profit percentage:
Gross profit ($5,000) divided by contract price ($10,000) = 50%

REMEMBER: Installment sale basis is adjusted basis plus sale expenses, plus ordinary income depreciation recapture (if any).

INSTALLMENT SALES

EXAMPLE OF MORTGAGE IN EXCESS OF BASIS

Selling price $9,000.

Buyer pays $3,000 (plus interest) over the next three years AND assumes an existing mortgage of $6,000.

Adjusted basis in the property is $4,400

Selling expenses are $600.

The part of the mortgage that is in EXCESS of "installment sale basis" is $1,000.
($6,000 - $5,000).

This amount is included in the CONTRACT price AND is treated as payment received in year of sale.

Contract price:

Sale price $9,000 less mortgage ($6,000)
PLUS excess mortgage ($1,000)= $4,000.

Gross profit:

Sale price ($9,000) less basis (4,400) less sale expenses ($600) = $4,000

Gross profit percentage:

Gross profit ($4,000) divided by contract price ($4,000) = 100%

Payment in year of sale:

$1,000 excess mortgage over basis plus any payments on the $3,000 balance

INSTALLMENT SALES

PAYMENTS RECEIVED

WRAP AROUND MORTGAGES

If mortgage of seller is **not** paid off OR assumed by buyer, the installment arrangement is known as a "wrap around mortgage".

Payments received generally enough to make payment on original mortgage

Temporary reg 15A.453-1(b)(3)(ii) which required that wrap around mortgage be treated as an "assumed mortgage" was overturned by the tax court.

Tax court in Stonecrest v Commissioner 24 T.C. 659 (1955) determined that the regulation relating to "subject to" mortgages or "assumed" mortgages did not apply to wrap around obligations.

THEN, the above temporary regs were issued after Installment Sales Revision Act of 1980.

THEN, in 1987 in 89TC No. 15 Professional Equities Inc. vs Commissioner the tax court upheld the Stonecrest decision and ruled that the temporary regs were contrary to the goals of section 453 and contrary to the Stonecrest case.

A WRAP AROUND MORTGAGE IS NOT CONSIDERED AN ASSUMED MORTGAGE UNDER THESE TAX COURT RULINGS.

In wrap around situations, generally taxpayer is considered to have received a payment, even though not paid directly. (Buyer pays (but not assumes) debt) (i.e. through escrow account). Allocation of interest and principal are based on the buyer's debt to seller, and installment amounts have no bearing on the underlying loan balance or interest.

Note: The interest paid on the underlying loan which the seller is still liable for is reported by seller as investment interest paid. - Bad news if seller can not itemize!!

Warning for client - May be a good deal on interest income rate but should contain early payoff penalty clause - if buyer pays off early could create unwanted tax consequences for seller (all of the remaining gain reported in one year)

INSTALLMENT SALES

CANCELED MORTGAGE

Assignment back to mortgagor (bank) and forfeiture of equity

This is a common occurrence in today's real estate market.

SELLER (OR PERSON WHO FORFEITS) MAY HAVE GAIN ON THE SALE.

If buyer is the person who holds the mortgage on it, debt is NOT assumed. It is CANCELED. Seller is considered to receive a payment equal to the amount of the outstanding debt.

Example #1:

Mary Jones loaned you $4,500 in 2003 in exchange for a note mortgaging a tract of land you owned.

On April 4, 2008, she bought the land for $7,000.

At that time $3,000 remained outstanding on her loan to you.

She agreed to forgive the loan balance and pay you $2,000 (plus interest) on August 1, 2008 and again on August 1, 2009.

Mary did NOT assume an existing mortgage.

She canceled a debt you owed her.

The effect is that you received a $3,000 payment at the time of the sale.

Example #2:

Taxpayer purchased property for $50,000 in 2008 and paid $5,000 down payment.

The balance of the purchase price was financed with the Dept. of Veterans Affairs.

In 2009, he can no longer make the payments and voluntarily gives the property back to the ODVA.

The balance on the mortgage at the time of the voluntary repossession since taxes had been added back each year.

Taxpayer has a sale for $52,000 and ALL of the $52,000 is received in year of sale. There is NO installment sale here but there is a gain of $2,000.

If the sale results in a loss **and it is a personal residence** it is a non-deductible loss
Be sure to consider **prior deferred gains** in computation of gain on the voluntary repossession.
If taxpayer in example #2 had deferred a gain from a former residence into the property he purchased in 2008 for $50,000, his basis, of course would be reduced by the deferred gain and he could face taxable gain of quite a large amount, even though he is now losing the home.

INSTALLMENT SALES

PAYMENTS RECEIVED

LIABILITIES OF THE SELLER

If buyer pays off sellers debt:

Considered a payment in year of sale

If buyer assumes sellers debts as his own:

Part may be treated as a payment.

If debt is LESS than the installment sale basis:

None is payment in year of sale.

If debt is MORE than the installment sale basis:

Difference is treated as payment in year of sale.

The above applicable only to debts in connection with ownership of the property or acquired in ordinary course of trade or business.

IF BUYER ASSUMES ANY OTHER TYPE OF DEBT (i.e. personal loan):

Treated the same as if buyer had paid off the debt at the time of sale.

Value of the assumed debt considered payment in year of sale.

PAYMENTS OF PROPERTY

Considered a payment (unless like kind exchange)
Value of property received is FMV.

INSTALLMENT SALES

PAYMENTS RECEIVED

THIRD PARTY NOTES

If buyer gives a third-party note (or other third party obligation), seller is considered to receive a payment equal to the note's FMV.

Payments received later on the note are NOT considered payments on the sale. If FMV is less than the face value, a part of each payment must be reported as ordinary income.

Example: Real estate sold in an installment sale. As part of the down payment, buyer assigns a $5,000, 12% note of a third party. FMV of the note at the time of the sale was $3,000. $3,000, not $5,000 is considered payment in year of sale. Because the note had a FMV equal to 60% of its face value ($3,000 divided by $5,000), 60% of EACH payment of principal is return of capital. The remaining 40% is ordinary income but NOT a part of the installment sale.

OBLIGATIONS PAYABLE ON DEMAND

Are part of payment in year of sale. (i.e. bonds that can be readily traded in an established securities market).

DEPRECIABLE PROPERTY SOLD ON CONTRACT

Gain **IN EXCESS OF RECAPTURE** amount can be reported on installment method.

See prior information

INSTALLMENT SALES

RELATED PARTY RULES - INSTALLMENT SALES

- **Sales of DEPRECIABLE property to a related party - can NOT use the installment method**

  Definition: 'Depreciable Property' for installment sale rules:
  Any property that can be depreciated **by the person to whom is transferred**.

  "Related persons" - spouse, 50% owned entity, two 50% owned entities, beneficiary, trust, executor - ***note -not the same as related persons for application on NON depreciable property (below)***

- **Sale and Resale - Related Party Rules- NON DEPRECIABLE property**

  Sale to a related person on installment basis who then sells or otherwise disposes of the property.

  "Related persons" Spouse, children, grandchildren, parents, grandparents, brothers, sisters, 50% owned corporation, partnerships, trusts, estates that are related persons under general stock attribution rules of corporate stock ownership.

  Second sale can, in effect, cancel the installment method for first sale.

  If second disposition within 2 years and before all payments are made: (except if after death of first party or second party) then:

  Part of the amount the related person realizes as a result of the second disposition is treated by the FIRST seller as received from the FIRST disposition. (Received at time of second disposition)

Continued

INSTALLMENT SALES

RELATED PARTY RULES - INSTALLMENT SALES

LIMIT ON AMOUNT TREATED AS RECEIVED:

(As result of second disposition)

- Smaller of:
  a) Contract price of first disposition
  b) Amount realized from second disposition
- Sum of all payments received by end of tax year from FIRST disposition PLUS sum of all amounts required to TREAT as if received in earlier years as result of second disposition
- Subtract result of #2 from #1. If zero or less, no amount is realized on the second disposition.

Amount realized on the SECOND disposition is further reduced by amounts that are attributable to improvements by RELATED PERSON after the FIRST disposition

Later Payments treated as amounts already paid

If gain recognized because of second disposition, any later payments received are tax free until they total more than the amount realized from the second disposition which caused recognized gain

RELATED PARTY RULES - INSTALLMENT SALES

EXCEPTION IF TAX AVOIDANCE IS NOT A PRINCIPAL PURPOSE

Second disposition rules do not apply if taxpayer can show that neither disposition was for avoidance of Federal income tax (i.e. foreclosure or bankruptcy)

EXAMPLE OF SECOND DISPOSITION GAIN

In 2005 Harvey sold farmland to his son Bob for $500,000 which was to be paid in five equal payments over 5 years plus adequate stated interest on the balance due. Harvey's installment sale basis for the farmland was $250,000 and the property was not subject to any outstanding liens or mortgages. His gross profit percentage is 50%. Harvey received $100,000 in 2005 and included in his net income for that year $50,000 (50% of $100,000). Bob made no improvements to the property and in 2006, he sold it for $600,000 (to a non-related party.)

Harvey figures his installment sale for 2006 as follows:

Amount realized on property sold by Bob ($600,000) or contract price ($500,000) whichever is smaller	$500,000
Minus: Sum of payments from Bob in 2005 and 2006	(200,000)
Amount treated as payment because of second disposition	$300,000
Add payment from Bob in 2006	$100,000
Total payment received and treated as if received in 2006	$400,000
Multiplied by gross profit percentage	50%
Installment sale income for 2006	$200,000
	=========

Harvey will NOT include in his income from installment sales any principal payments he receives on the installment obligation for 2007,2008, 2009 because he has already reported the entire amount of the payments from the first disposition of $500,000. ($100,000 in 2005 and $400,000 in 2006)

GAIN NOT RECOGNIZED ON SECOND DISPOSITION

If, on the second disposition you still have not recognized the entire gain from the first disposition, you will recognize gain on later payments at the point that the sum of all payments received are more than the sum of prior payments already received on which you recognized gain plus the amount you were considered to have received as a result of the second disposition on which you recognized gain. If the facts were the same as the above example EXCEPT that Bob sold the property for only $400,000:

Amount realized on 2nd disposition or contract price (lesser of)	$400,000
Minus sum of payments from 2005 and 2006	(200,000)
Amount treated as payment because of second disposition	$200,000
Add payment from Bob in 2006	$100,000
Total payments received and treated as received in 2006	$300,000
Multiplied by gross profit percentage	50%
Installment sale income for 2006	$150,000
	=========

The 2007 and 2008 payments of $100,000 each from Bob are **NOT** taxed.
In 2009, he would recognize gain on the final $100,000.

INSTALLMENT SALES AND LIKE KIND EXCHANGES

Section 453(f)(b)

In a like kind exchange, you do not report any part of your gain that comes from the like kind property you receive.

If you receive money or other (unlike) property, you must report that portion as gain.

Installment obligation in like kind exchange:

- ★ Contract price does NOT include FMV of like-kind property received
- ★ Gross profit is reduced by gain on the trade that can be postponed (the gain related to the like kind portion)
- ★ Like kind property received in the exchange is NOT considered a payment on the installment obligation but IS used for the purpose of determining whether the sale qualifies as an installment sale.

CONTINGENT SALES

A contingent sale is a sale for which total selling price can not be determined by the end of the tax year in which sale takes place. Special rules apply.

ALLOCATION OF SALE AND DOWN PAYMENT

If a sale includes different assets (such as land, buildings, furniture or goodwill) in a single sale, you **MUST ALLOCATE:**

- ★ Sale price
- ★ Sale expenses
- ★ Payments received.

EXAMPLE ALLOCATION:

Farm purchased for $500,000, plus purchasers cost of $40,000,
PLUS back taxes (in addition to purchase price) of $10,000 for total of $550,000.

County assessed valuations at date of sale were:

Land	$160,000	64%
Residence	50,000	20%
Farm buildings	40,000	16%
Total ASSESSED	$250,000	100%
	=========	=====

Total PURCHASE price (cost above was $550,000.)

Allocated to land:	64% x $550,000 = $352,000
Allocated to personal residence:	20% x $550,000 = $110,000
Allocated to farm buildings:	16% x $550,000 = $8,800

Note: Further allocation would be required to determine the cost of ONE acre of the land and allocate it to the residence.
Divide total land by number of acres.

<u>ELECTING OUT OF INSTALLMENT TREATMENT</u>

Section 453(d)(1)

You can CHOOSE NOT to have the installment sale rules apply.

Installment sale rules are mandatory UNLESS you elect OUT.

> ***<u>Warning: When installment method is used for regular tax it is also used for Alternative minimum tax. Electing OUT of installment method will cause election OUT for AMT also and may result in major tax consequences</u>***.

When you elect OUT of the installment sale you do not ALWAYS report the entire gain in the year of sale.

If <u>cash method</u> taxpayer, generally full gain IS reported in year of sale. but if FMV of the contract is not the same as face value, there MAY be adjustments required.

When you elect out, you must compute the buyer's obligation at FMV to arrive at the selling price.

If you do NOT elect OUT, these obligations are included at full face value.

<u>Example</u>:

You sold a parcel of land to another person for $50,000, payable at $10,000 down and a balance over a period of 10 years at $4,000 a year plus 12% interest.

The buyer gave you a note for $40,000. The note had a fair market value of $30,000 (75% of its face value) You paid a brokers commission of 6% ($3,000). The land cost you $25,000 and you owned it for more than 6 months. You decide to elect OUT of the installment method and report the buyer's note at its fair market value.

<u>Computation of gain:</u>

Selling price:		$50,000
Less: Adjusted basis of	$25,000	
Commission paid	<u>3,000</u>	<u>(28,000)</u>
Gain **<u>realized</u>**		$22,000
		======

<u>Gain RECOGNIZED in year of sale</u>:

Cash	$10,000
Market value of the note (75% of 40,000)	<u>$30,000</u>
Total REALIZED in year of sale	$40,000
Less: Adjusted basis and commission ($25,000 + $3,000)	<u>(28,000)</u>
Gain RECOGNIZED in year of sale	$12,000
	======

The $12,000 is long term capital gain. However, since you included only the fair market value of the note to compute gain recognized in year of sale, you must recognize as ordinary income 25% of each principal payment you receive each year.

MAY BE IMPORTANT IF CAPITAL GAIN RULES CHANGE AT A LATER DATE.

<u>ELECTING OUT OF INSTALLMENT TREATMENT</u>

If required to use FMV you must compute the FMV of the installment obligation whether you would actually be able to sell it or not.

If you are a <u>CASH METHOD</u> taxpayer, FMV. of the obligation is the same as face value and <u>REALIZED</u> AND <u>RECOGNIZED</u> gain are equal in year of the sale.

<u>FORM 6252, SCHEDULE D, OR FORM 4797?</u>

If electing OUT, do NOT report the sale on form 6252
Report on Sch. D, or form 4797 and complete election

If electing out AND value buyers installment obligation at less than FMV, complete additional part of sch. D or form 4797 (Part IV) and check the box provided, entering face value and percentage of face amount reporting in year of sale.

<u>ELECTING OUT IS AN IRREVOCABLE ELECTION. IT CAN NOT BE CHANGED WITHOUT IRS APPROVAL</u>

<u>REASONS TO ELECT OUT OF INSTALLMENT SALE TREATMENT</u>

- ★ Taxpayer has negative taxable income in year of sale or in a low bracket
- ★ Taxpayer has negative taxable income without an NOL being created.
- ★ Taxpayer may be in a higher tax bracket in the future
- ★ Loss or credit carryovers would be used that might otherwise go unused

<u>REASONS TO REPORT ON INSTALLMENT METHOD (NOT ELECTING OUT)</u>

- ★ Defer tax
  - Taxpayer may be in lower tax bracket in the future
  - Higher principal earns more interest
- ★ Prevent social security benefits from becoming taxable
- ★ Other AGI driven tax items should be considered (i.e. phase out of itemized deductions)

<u>BE SURE TO CONSIDER ALTERNATIVE MINIMUM TAX EFFECTS OF THE DECISION TO REPORT ON INSTALLMENT METHOD OR ELECT OUT.</u>

UNSTATED INTEREST

BOTH buyer and seller must treat a part of each installment payment as interest.

If interest is NOT stated in the agreement or if interest is lower than the prescribed amounts, a portion of the stated principal is PRESUMED to be interest.

UNSTATED INTEREST RULES APPLY IF: (Section 483 rules)

- some or all of payments are due more than one year after date of sale/exchange

AND

- There is total unstated interest.

AND THEN unstated interest is figured on any payment that meets following conditions

- Payment constitutes all or part of the selling price
- Payment is due more than **six months** after date of sale or exchange

TOTAL UNSTATED INTEREST:

An amount equal to the **EXCESS of:**

- ♦ the sum of the payments due under the contract

OVER

- ♦ the sum of the present value of the payments and present value of any interest payments due under the contract.

APPLICABLE FEDERAL RATE

Depends on the month the contract is made and the term of the instrument.

- ♦ Three years or less, AFR is federal short term rate
- ♦ Over three years but not over nine years, AFR is federal Mid term rate
- ♦ over nine years AFR is federal long term rate.

AFR published monthly in IR bulletin. Information is available by contacting IRS office.

UNSTATED INTEREST

TEST RATE OF INTEREST:

Test rate is 3 month rate which lower of:

- Lowest AFR in effect during 3 month period ending with first Month in which there is a binding written contract that substantially sets forth terms of contract
- The lowest AFR in effect during the 3 month period ending with the month in which sale or exchange occurs.

Special rules:

For sales or exchanges of property (other than new section 38 property which includes most tangible personal property) involving seller financing of $4,280,800 or LESS, the test rate of interest cannot be more than 9% compounded semi-annually.

For seller financing over $4,280,800, and for all sales or exchanges of New section 38 property, the test rate of interest is 100% of the AFR.

UNSTATED INTEREST RULES APPLICABLE TO:

- Debt instruments from sales or exchanges of:
    - A farm for $1,000,000 or LESS by:
        - An individual
        - An estate
        - A small business corporation (1244)
        - A domestic partnership that meets requirements similar to 1244(c)(3)
    - A main home by the owner
    - Property with total payments (principal and interest) of $250,000 or LESS.
    - LAND between related parties
- A cash method debt instrument

DOES NOT APPLY TO:

Sales of $3,000 or less
Carrying charges.
Publically traded debt instruments or property
Patents
Annuities - payments that depend in whole or in part on life expectancy
Personal USE property .

UNSTATED INTEREST

LAND SALES BETWEEN RELATED PARTIES

Unstated interest rules apply to land sales between related parties TO THE EXTENT that the total stated principal of the debt instrument issued in the sale or exchange does not exceed $500,000 when added to total stated principal of any other debt instruments for prior land sales between these individuals during the calendar year..

Related parties - individual and members of individual's family and spouses.

Individuals family include spouse, brother and sister (whether whole or half), ancestors, and lineal descendants.

ELECTING OUT OF INSTALLMENT SALE - UNSTATED INTEREST

If you elect out of the installment sale and payments would include unstated interest, you must reduce selling price by total amount of unstated interest before computing gain or loss.

DISPOSITION OF INSTALLMENT OBLIGATION

DISPOSITION:

When rights of seller under installment obligation disappear or are materially changed.

GAIN OR LOSS ON DISPOSITION:

Considered gain or loss on original sale

CHARACTER OF GAIN OR LOSS

Remains same (ordinary/capital) as original sale

SALE OR EXCHANGE OF OBLIGATION-

Gain or loss is difference between basis in the obligation and amount realized. (Assignment of **part of the payments** on the contract in exchange for advanced funds - loan - is a sale of the payments and payments should be reported in the same manner as if they were received according to the agreement {interest and principle}. There should be some underlying investment interest on the loan if the loan is for business purposes)
Exception - Pledge rule if sale price is over $150,000 - see pledge rule later

OTHER DISPOSITIONS:

Gain or loss is difference between basis in the obligation and FMV at disposition.

TRANSFERS BETWEEN SPOUSES OR FORMER SPOUSES

No gain or loss recognized on the transfer
Same tax treatment applies to receiver as to transferor
Basis of obligation same to transferee as to transferor

GIFTS OF INSTALLMENT SALE OBLIGATIONS

A disposition whose Gain or Loss is the difference between Basis in obligation and FMV at time of gift

CANCELLATION

Cancellation of the obligation is a disposition

Gain or loss is difference between basis in the obligation and FMV at cancellation.

IF RELATED FMV is considered to be NO LESS THAN FULL FACE VALUE

DISPOSITION OF INSTALLMENT OBLIGATION

DISCOUNTED CONTRACT

Settlement is treated as a disposition

Gain or loss is difference between basis in the obligation and amount REALIZED on settlement.

Reducing selling price but not forgiving rest of debt is NOT disposition

Seller recompute gross profit using adjusted sales price, then subtract profit already reported and spread the remaining gain over the remaining installments.

Re-compute gross profit percentage and apply to future payments.

ASSUMPTIONS

If assumed at original installment obligation NOT a disposition

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.

DISPOSITION OF INSTALLMENT OBLIGATION

BASIS OF THE OBLIGATION

Basis in the installment obligation is NOT the same as basis in the sale or property sold.

Basis in the obligation represents the part of original adjusted basis in the property sold that you have not already recovered in payments from the buyer.

It depends on the amount yet to be paid (unpaid balance) AND gross profit percentage.

MULTIPLY:

- Gross profit percentage
  TIMES
- Unpaid balance of contract

EQUALS:

- Unreported PROFIT

SUBTRACT:

- Unreported Profit

FROM:

- Balance of the contract

EQUALS:

- BASIS IN THE OBLIGATION

Basis in the obligation represents the part of your original adjusted basis in the property sold that you have not already recovered in payments from the buyer.

EXAMPLE:

Several years ago you sold some property on the installment method. The buyer still owes you $10,000 of the sales price. This is the UNPAID BALANCE on the buyer's installment obligation. Gross profit ratio is 60%.

60% of the $10,000 due = the profit still due you

Total contract balance of $10,000 less $6,000 unreported profit = $4,000 basis in the obligation.

<u>REPOSSESSIONS</u>

If, after making an installment sale, you repossess your property from the buyer, you may have to figure:

- Your gain (or loss) on the repossession

AND

- Your basis in the repossessed property.

The rules for computation depend on the type of property (real or personal)

Repossession rules apply whether or not title to the property was ever transferred.

Discharged obligation must be one that is secured by property repossessed.

<u>Briefly:</u>

Gain on repossession is the difference between the amount of money and the FMV of property (other than the obligation) you have received and the total amount of gain you have already reported.

Limited to:

- gain on the sale originally

PLUS

- repossession costs.

<u>SPECIAL RULES APPLY FOR REPOSSESSION OF A FORMER PERSONAL RESIDENCE WHERE A DEFERRAL OR ONCE IN A LIFETIME EXCLUSION HAS BEEN TAKEN.</u>

<u>REPOSSESSIONS IS A SEPARATE AND INVOLVED SUBJECT</u>

CLOSING STATEMENTS

It is important that tax preparers be able to read closing statements properly. A closing statement is a "simple" application of basic accounting for double entry bookkeeping: Debits equal Credits.

EXAMPLE FOR SELLER: (Sold a rental duplex)

	DEBIT	CREDITS
Total sales price		$44,950.00
Deed of trust (note)	$27,450.00	
Commission to R. E. agency	4,495.00	
Payment of back taxes	2,138.08	
Payment of current year taxes (2002-03)	593.25	
Prorate of county taxes 4/10-6/30		125.56
Fire insurance		130.65
Prorated rents	578.50	
License		100.00
Transfer fees	100.00	
Balance due to seller	9,951.38	
	$45,306.21	$45,306.21
	========	=========

The **CREDIT** column reflects the sales price and refunds of prior expenses
The sales price is NOT increased by any items that are refunds.

In the above example:
Sales price is $44,950
Prorate of taxes 125.56 is a REFUND of the current year taxes which the full year has been paid (out of the sale funds) by the seller. This is not an item subject to tax benefit rule since it is a refund of the CURRENT year taxes. It would simply reduce the current year tax deduction.
Fire insurance credit indicates that the buyer is assuming the insurance that the seller has already paid for and the refund to the seller would be taxable based on tax benefit rule.
License refund of $100 indicates an assumption by the buyer of a license previously paid for by the seller and is a refund subject to tax benefit rule if paid in a prior year.

The **DEBIT** column simply reflects the distribution of the sales price funds.
Of the $44,950 due the seller, plus refunds due the seller, the funds were USED for:
Paying real estate commission, back taxes and current year taxes
Paying the transfer fee
Buyer still owes $27,450 of the selling price on a contract
Seller had collected rents on the duplex in advance and the buyer is entitled to $578.50 of the rents from closing date until the date they were paid to.
Effectively, the closing statement is PAYING the buyer these rents.
Cash was paid to the seller in the amount of $9,951.38

A CLOSING STATEMENT TELLS YOU WHERE THE MONEY CAME FROM AND WHERE IT WENT.

DEBITS ON THE SELLERS STATEMENT HAVE NO EFFECT ON SALES PRICE.

The back taxes paid in the above example indicate that they used funds from the sale to pay the taxes for the SELLER and they are a current year **deduction for the SELLER.**

CLOSING STATEMENTS

Example for **BUYER** of the rental duplex:

	DEBITS	CREDITS
Total purchase price	$44,950.00	
Deed of trust (note)		$27,450.00
Pro-rate of taxes	125.56	
Fire insurance	130.56	
Prorated rents		578.50
License	100.00	
Cash due on closing		17277.71
Totals	$45,306.21	$45,306.21
	========	========

For the **BUYER**, the **DEBIT** side indicates the purchase price plus any additional costs or expenses. In the above example all of the additional items are CURRENT year expenses which buyer may deduct in the current year.

Cost BASIS is NOT increased by current year deductible pro-rated expenses.

The CREDIT side simply indicates HOW the buyer paid for the property:
He gave a note of $27,450
He applied the 578.50 rent money he "effectively" received from the seller
He paid $17,277.71 in cash
The **CREDITS for the BUYER have no effect on cost basis**.

IF ANY OF THE DEBITS FOR THE BUYER ARE DIRECTLY RELATED TO THE PURCHASE OF THE PROPERTY INSTEAD OF CURRENT DEDUCTIONS APPLICABLE TO THE INCOME PRODUCING PART OF THE PROPERTY OR PERSONAL ITEMIZED DEDUCTIONS, THEN THE AMOUNTS DIRECTLY ASSOCIATED TO THE PURCHASE ARE ADDED TO THE BASIS.

If, in the above example, a debit amount of $50 was entered for escrow fees, it would be an addition to basis.

Note that the cash due from buyer is not the same as cash due to the seller on the previous page. Part of the cash received from the buyer was used to pay some of the seller's expenses which had no bearing on the buyers statement.

The prorated rents "effectively" received by the buyer must be included as rental income in year of purchase.

If SELLERS statement showed:	DEBITS	CREDITS
Sales price		$44950.00
Assumption of back taxes		2,138.08

This indicates that buyer is assuming the back taxes IN ADDITION to the sales price (rather than paying them off). The additional 2,138.08 is forgiveness of debt and seller must include them in sales price. Buyer must include them in basis. The buyer had no legal obligation to pay these taxes AT THE TIME THEY WERE ASSESSED and can not, therefore, deduct them as current year taxes deductions.

INSTALLMENT SALES - PLEDGE RULE
Section 453A

Installment obligation used as security (pledge rule)

If use an installment obligation to secure any debt, net proceeds from the debt may be treated as payment on the installment obligation.

Applies if selling price of property was over $150,000 and outstanding obligations exceed $5,000,000 at year end. All sales which are a part of a single transaction or a series of related transactions are treated as one sale.

Does NOT apply to following dispositions

- Sales of property used or produced in farming
- Sales of personal use property
- Qualifying sales of timeshares and residential lots

Net debt proceeds = gross debt minus direct expenses of getting the debt. Treated as a payment received on later of either of:

Date debt becomes secured
Date you receive debt proceeds

A debt is secured by installment obligation to the extent that payment of principal or interest on the debt is directly secured (under terms of the loan or underlying agreement) by any interest in the installment obligation.

Limit: Net debt proceeds treated as a payment on the pledged installment obligation cannot be more than the ***excess of***

1. The total contract price on the installment price

over 2. Any payments received on the installment obligation before date the net debt proceeds are treated as a payment.

(Gain reportable, regardless of amount of debt secured by the installment agreement, can not be more than the original reportable gain less amounts already reported)

INTEREST received on the payments on which accelerated reporting is required is still taxable as received.

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 are more than the amount reported under pledge rules.

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