Maximize Profits and Defer Taxes with an Installment Sale

Do you own investment property? What about a small business? Sooner or later, you will probably want to sell.

One of the downsides of selling a business or investment property is the huge tax bill at the end. Profits are likely subject to the capital gains tax—perhaps at a much higher rate than you expect.

A seller-financed installment sale enables you to defer taxes to one or more later years, which is almost always a good idea.

And the installment sale could cut your tax bill if spreading out your profits over multiple years puts you in a lower tax bracket.

But as with most programs that can lower your taxes, your lawmakers and the IRS impose a number of limitations, as we will explain.

What Is an Installment Sale?

An installment sale is a sale of eligible property where you receive at least one payment after the close of the taxable year in which the sale occurs. If you make a profit on an installment sale, you report part of your profit when you receive each payment.

You document the buyer's obligation to make future payments to you, with a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to you. You should also secure the debt.

Although you can't use the installment method to report a loss, you can choose to report all of your gain in the year of sale.

Installment Sale Advantages

An installment sale offers a number of advantages for you as a seller, as well as for your buyer:

1. You can negotiate the sale without the need for the buyer to pay the full sale price when you finalize the sale.

2. You and the buyer can finalize the sale agreement without waiting for the buyer to qualify for third-party financing.

3. You and the buyer can tailor the terms of the sale to meet your needs without having to get approval from a third-party lender.

4. You can defer taxes on your gain, and potentially pay a lower tax rate in a later year.

5. The buyer receives full basis in the property.

How Is an Installment Sale Reported?

Payments that you receive from an installment sale consist of three parts:

1. Interest

2. Taxable part (gain or profit)

3. Non-taxable part (return of basis)

Each year you receive a payment, you pay taxes on the interest and taxable part. The part of the payment allocated to your basis is not taxable. Basis is the amount of your investment in the property for installment sale purposes.

After you've determined how much of each payment to treat as interest, you next determine the taxable portion of the remaining payment.

Example. You sell property at a contract price of $600,000, and your gross profit is $150,000. Your gross profit percentage is 25 percent ($150,000 ÷ $600,000). After subtracting interest, you report 25 percent of each payment, including the down payment, as installment sale income from the sale for the tax year in which you receive the payment. The remainder (balance) of each payment is the tax-free return of your adjusted basis.

Say your buyer makes a payment of $12,250, of which $2,250 is interest. Of the remaining $10,000, $2,500 (25 percent) is taxable profit and $7,500 is non-taxable return of basis.

No Installment Sale in These Instances

There are certain types of property and transactions for which the installment method cannot be used, such as:

- The sale of inventory consisting of personal property. But this rule does not apply to property used or produced in farming.

- The sale of real property held for sale to customers in the ordinary course of a trade or business. But dealers of timeshares and residential lots can treat certain sales as installment sales and report under the installment method if they elect to pay a special interest charge.

- The sale of stock or securities traded on an established securities market.

- The sale of depreciable property to a related buyer, unless you can show to the satisfaction of the IRS that the sale was not made for tax avoidance.

Minimum Interest Requirements

Interest earned from an installment sale must be reported as ordinary income. Interest is generally not included in the down payment. But you will have to treat part of each later payment as interest, even if it's not called "interest" in your agreement with the buyer.

Because the possibility exists for sellers to manipulate their tax bill by charging an unreasonably low rate of interest and inflating the sales price in an installment sale, the tax law requires you to charge a minimum rate of interest equal to the lower of 9 percent or the applicable federal rate (AFR), which the IRS publishes monthly. For July 2022, the minimum annual interest for a 15-year installment note is 3.22 percent. Thus, for an installment sale in July 2022, your installment note must call for 3.22 percent interest or more.

If the correct amount of interest is not stated in your agreement, the IRS will impute interest at the lower of 9 percent or the applicable AFR.

Sales to Relatives and Other Related Parties

If you sell depreciable property on an installment contract to your brother, sister, spouse, parent, grandparent, child, or grandchild and that relative sells the property within two years of acquiring it from you, you are treated as receiving a payment equal to what your relative received.

In other words, under this two-year requirement, the law treats the sale by your relative as if you were the seller.

Bad news for you.

You are treated as if you have the cash, which you don't. Your relative has the cash. And now you are going to pay taxes as if you have the cash.

The two-year resale rule also applies to sales by you to the following entities:

- Corporations in which you and your relatives directly or indirectly have 50 percent or more ownership

- Partnerships in which you have an interest

- Trusts naming you as a beneficiary

- Grantor trusts that treat you as the owner

Avoid Intermediary Installment Sales

To avoid the uncertainty concerning whether you might actually get paid the contract sales price in an installment sale, you may be tempted to engage in an intermediary installment sale.

Intermediary installment sales are marketed transactions that involve an intermediary who is formally independent from the seller but who, practically speaking, is a paid agent of the seller.

The intermediary purports to buy the asset from the seller for an installment note, receiving a cost basis. The intermediary then immediately sells the asset, tax-free, to a prearranged buyer for the same price in cash, which is used to service the installment note.

This arrangement avoids the uncertainty, involved in any installment arrangement, that the buyer might default on the note and you might not be paid in full.

But the IRS position is that such an arrangement lacks economic substance and is therefore not really an installment sale between two independent parties. Thus, the IRS will treat an intermediary installment sale in the same manner as it treats an installment sale to a family member or other related party.

Takeaways

Here are some key insights from this article.

- The installment sale enables you to defer tax on your gain, and likely also to have your gain taxed at a lower tax rate.

- You have considerable flexibility in establishing the terms of sale, but the IRS does require at least a minimum interest rate.

- Sales to related parties generally are disallowed unless the related party keeps the property for at least two years before selling.

- Intermediary installment sales lack economic substance and are disallowed under the two-year related-party rules.